

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
BRIEF**

No. 77-6034

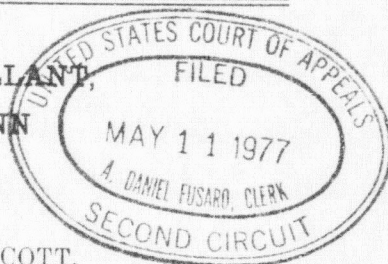
IN THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

In the Matter of
WEIS SECURITIES, INC., Debtor,
GEORGE ALDRICH, et al.,
vs.
EDWARD S. REDINGTON, Trustee, and
SECURITIES INVESTOR PROTECTION
CORPORATION,

Appellants,
Appellees.

Appeal from the United
States District Court
for the
Southern District
of New York

BRIEF FOR APPELLANT,
EVA GROSSMANN



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Oral Argument Requested

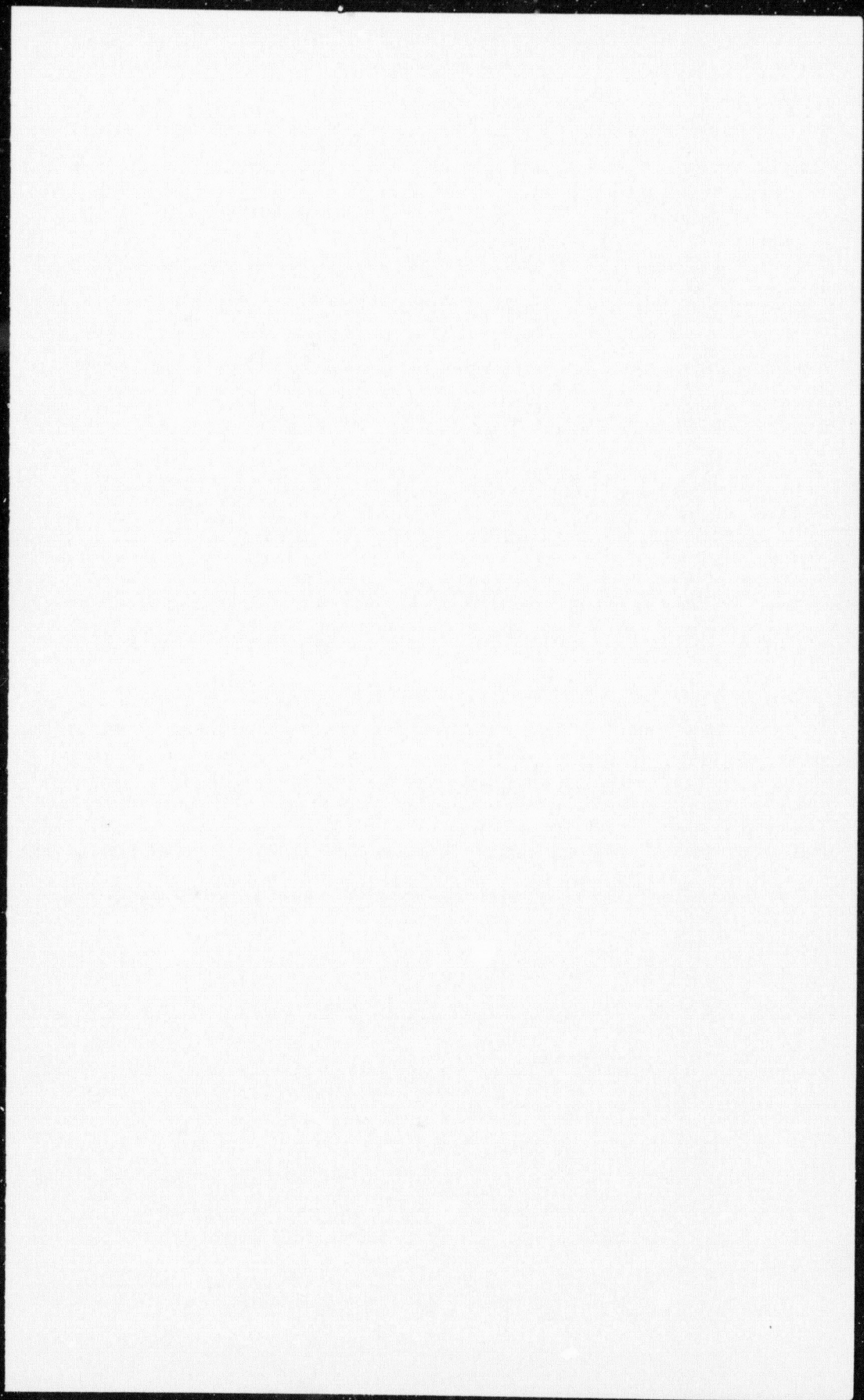


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Legislative History:

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**BRIEF FOR APPELLANT,
EVA GROSSMANN**

**STATEMENT OF
SEPARATE AND ADDITIONAL ISSUES**

1. Did the claimant, Eva Grossmann, ever occupy the status of a subordinate debenture holder?
2. Was and is the money obtained in breach of a confidential relationship and fraudulently from claimant, Eva Grossmann, by Weis, Voisin, Cannon, Inc., and later

transferred by that brokerage firm to Weis Securities, without the knowledge of claimant, held by Weis Securities, the bankrupt, under a constructive trust for the claimant?

3. Did even a pro forma *subordinate* debenture agreement come into existence with respect to Five Thousand Dollars (\$5,000.00) given by claimant, Eva Grossmann, to Weis, Voisin, Cannon, Inc., if no such evidence manifested by a debenture certificate was ever issued to or received by claimant, Eva Grossmann, and no other mention was ever made to claimant that said \$5,000.00 were held under a *subordinate* debenture agreement?

4. Did Weis, Voisin, Cannon, Inc., fraudulently induce the claimant to part with her life savings in gross violation of the suitability rules ("Know Your Customer Rule") of the New York Stock Exchange, the Illinois Securities Law (Ill.Rev.Stat., ch. 121½, Sec. 137.12) and the provisions of the Illinois Consumer Fraud Act. Ill.Rev.Stat., ch. 121½, § 261 *et seq.*?

5. Did the New York Stock Exchange violate its regulatory duties under the Securities Exchange Act of 1934 in approving the so-called subordinate debentures to claimant, Eva Grossmann, and thereby contribute to the fraud practiced upon claimant, thus conveying the impression to claimant that the transaction was legal, and are, therefore, the New York Stock Exchange, and the Trustee, who in part acts in the interest of the Exchange, estopped from raising the technical defense of the net-capital requirement allegedly relied upon by the bankrupt's creditors?

6. Was and is the Trustee estopped from denying that claimant, Eva Grossmann, is protected by the Securities Investor Protection Act?

7. Does the estoppel theory adopted by the District Court violate the spirit of the Securities Investor Protec-

tion Act and lead to the victimizing of innocent brokerage firm customers in clear contravention of the purpose and intent of the Act?

8. Was the transfer of Weis, Voisin, Cannon's business to Weis Securities and the corollary transfer of claimant's funds from Weis, Voisin, Cannon, Inc., to Weis Securities, without the claimant's knowledge and consent, in violation of the Illinois and New York Bulk Sales Acts?

9. In the alternative, did the transfer of claimant's funds from Weis, Voisin, Cannon, Inc., to Weis Securities, without ever issuing any debenture certificate whatsoever to claimant, place the claimant in the status of a general creditor vis-à-vis the bankrupt, Weis Securities?

STATEMENT OF THE CASE

Nature Of The Case

This brief is filed by Attorney General William J. Scott of Illinois, in behalf of claimant, Eva Grossmann, in addition to and supplementing the main brief filed by all appellants. The filing of this brief has been necessitated by the District Court's treatment of Mrs. Grossmann—a poor widow deprived of all her life savings by the unscrupulous and fraudulent practices of a stock broker—as a “subordinate” debenture holder although she has neither comprehended the import of that type of security nor understood its characteristics. Hence this appeal which is brought against the District Court's Order, granting the Trustee's motion for summary judgment in liquidation proceedings against a bankrupt stock broker under the provisions of the Securities Investor Protection Act, involves important questions affecting not only the claimant but also the public interest in general.

Statement Of Facts

Mr. William J. Scott, the Attorney General of the State of Illinois, acts in the present proceedings on behalf of Mrs. Eva Grossmann, an Illinois citizen and resident, who has filed a claim in the liquidation proceedings of the debtor, Weis Securities, Inc., on August 25, 1973 (A 170).

Mrs. Grossmann, a native of Romania, who had spent several years in Nazi concentration camps, immigrated to the United States with her husband in 1950 (GA 14, A 336)*. She found a job as a fitter in a Chicago department store where she is still employed. When her husband passed away, she received the sum of \$5,000 on her husband's life insurance (GA 15, A 337). She mentioned her circumstances to one of her customers, a Mrs. Meiselman, who told her to see and consult her husband, Mr. Leo Meiselman, executive vice-president of Weis, Voisin, Cannon, Inc., in Chicago, who had invested successfully funds for several widows and who would help and advise her in investing her money (GA 15, A 337). Mrs. Grossmann thereupon consulted Mr. Meiselman who told her he would properly invest her funds and directed her to turn over to Weis, Voisin, Cannon, Inc., first \$15,000 and later \$5,000 (the proceeds of her husband's life insurance) for a total of \$20,000, which constituted all of her life savings (GA 15-16, A 337). In return for the \$15,000, first given by her to Weis, Voisin, Cannon, Inc., she received a letter from

* Due to the numerous parties and the unavailability of either the Record or Joint Appendix during the preparation of this brief, a separate Appendix is included in this brief which contains documents also appearing in the Joint Appendix. For convenience references in this brief are made to the separate Grossmann Appendix (GA).

Since the filing of this brief the Joint Appendix has become available. For the Court's convenience parallel references to the Joint Appendix have been added and are cited as A . . .).

that firm dated June 29, 1967, in which the firm acknowledged receipt of two cashier checks (\$7,000 and \$8,000) in the total amount of \$15,000 and stated that the funds were "to be used to purchase two-year debentures . . ." (GA 7, A 146); nothing was mentioned about any "subordinate" debenture. Around that time she also received a certificate representing the purchase of a \$15,000 debenture issued by Weis, Voisin, Cannon (GA 8, A 147-48). When she later on, upon the urging of Mr. Meiselman, gave an additional amount of \$5,000 to Weis, Voisin, Cannon, no debenture certificate was ever issued to her (GA 17, A 338), but she merely received a letter acknowledging receipt of her check in the amount of \$5,000 and stating that the \$5,000 would be credited to her as "debenture account customer" (GA 9, A 149); no mention was made of a subordination clause (GA 9, A 149).

Mrs. Grossmann, who was completely naive and totally uneducated and unsophisticated as far as financial matters are concerned, relied solely upon the advice of Mr. Meiselman, whom she had consulted for investment purposes (GA 15-17, A 337-38). She never comprehended the character or significance of the term "debenture", let alone of "subordinate debenture", nor was she ever informed that the debenture received by her for the sum of \$15,000 was "subordinate" (GA 15, A 337). All necessary papers were signed by her upon Mr. Meiselman's direction and advice, including the application to the New York Stock Exchange for approval of subordinate status.

The debentures were automatically renewed by the brokerage firm (GA 10, A 150). Weis, Voisin, Cannon, Inc., was subsequently sold to or taken over by a different corporate entity, Weis Securities, Inc., the present bankrupt; however, Mrs. Grossmann never received any

notification of the takeover and for the first time learned of it through a letter sent to her by Weis Securities, dated April 27, 1973, informing her that the firm's auditors were making an examination of the firm's financial statements and that she should confirm her subordinate debenture account in the amount of \$20,000. Shortly thereafter, liquidation proceedings were commenced against Weis Securities, and she read in a Chicago newspaper of the firm's bankruptcy (GA 18, A 339). The liquidation proceedings against Weis Securities were instituted by the Securities Investor Protection Corporation in May, 1973, under the Securities Investor Protection Act of 1970 (hereinafter called SIPA).

The Trustee has taken the position in the liquidation proceedings that all so-called subordinate debenture holders, including Mrs. Grossmann, must be treated alike, regardless of any fraud practiced upon them, and that they are estopped from rescinding their subordinated loan agreements embodied in the debentures. In pursuance of that theory, he moved for a summary judgment which was denied by the Bankruptcy Judge because of the existence of material facts regarding which the court was unable to make findings for lack of probative evidence (GA 29, A 387).

The Trustee and the Securities Investor Protection Corporation (hereinafter called SIPC) appealed from the Bankruptcy Judge's denial of the motion for summary judgment. It should be mentioned in this connection that SIPC is a private non-profit corporation created by the SIPA which is subrogated to the claims of Weis Securities' customers to the extent that these claims are paid out of the insurance fund created by SIPA.

In reversing the Bankruptcy Judge's decision, the District Court held that actual reliance by the customers and general creditors upon the subordinate loan agreements must be presumed as a matter of law because the subordinated lenders, by their agreements, enabled Weis Securities to comply with the net capital rule and thus continue in business (GA 46, A 418-19).

It is from the District Court's Order of January 21, 1977, that this appeal is taken.

ARGUMENT

I.

NO VALID SUBORDINATE DEBENTURE AGREEMENT CAME INTO EXISTENCE.

A.

Mrs. Grossmann's Claim Raises Issues Not Shared By Other Claimants.

The claim of Mrs. Grossmann raises issues and is based upon facts separate and distinct from the claims of the subordinate lenders involved in the present proceedings. Hence, any attempt to place Mrs. Grossmann's claim in the same category as the claims of other debenture holders, as has been done by the District Court, without even bothering to ascertain whether Mrs. Grossmann does in fact occupy the legal status of a subordinate debenture holder, is not only improper and inappropriate, but amounts in effect to a gross violation of the most basic concept of due process in contravention of the Fifth Amendment to the United States Constitution. The District Court's decision deprives Mrs. Grossmann, with one swoop, of her right to set forth the salient points of her claim, which negate the valid and lawful existence of a "subordinate debenture" on her part. By the convenient device of summarily treating all claimants alike, without distinguishing their individual cases, and by pinning the label of "subordinated lender" upon Mrs. Grossmann and deducing therefrom certain legal consequences, without examining whether the application of that terminology is justified, the essence and legal basis of her claim are simply ignored. Thus, she is deprived by the District Court's ruling of her day

in court because she is unable to set forth the realities of her claim appearing in the record which demonstrate the lack of a true subordinate debenture agreement. Obviously, if she cannot be considered a subordinate debenture holder in legal contemplation, the reasoning of the District Court relative to her claim is spurious.

B.

The District Court Made Unwarranted And Improper Assumptions.

In painting all claimants with the same judicial brush, the District Court suggested that Mrs. Grossmann was a knowledgeable, sophisticated investor who "knowingly assume[d]" the risk of a subordinated investment in exchange for a generous rate of return. Nothing could be further from the truth. Here was a widow, completely ignorant in all matters of investment, who entrusted all her life savings to a stock brokerage firm upon the advice and direction of a high official of that firm whose counsel she had sought and in whom she had placed implicit trust. The nature of the investment which she was induced to make was beyond her understanding and comprehension. Thus the fraud perpetrated upon her went far beyond the making of false statements as to the firm's financial position and was, in reality, of a completely different character. Under these circumstances, the reasoning of the District Court that subordinated lenders in liquidation proceedings under SIPA are estopped, as a matter of law, from rescinding fraudulently induced agreements, is totally inapposite as far as Mrs. Grossmann's claim is concerned and bears no relation to the realities of her case. The Court, in reaching its conclusion, presupposed that the subordinated lenders *knew* that the subordination was to meet the statutory requirements for a broker-dealer to continue in business

and *knew* that it was for the protection of the general class of Weis' customers who, as long as Weis continued to operate, were becoming general creditors of Weis. Yet, to assume such knowledge on the part of Mrs. Grossmann is downright absurd. It may well have been that large, financially knowledgeable lenders, consciously loaning money to the debtor, were aware of the nature of subordination agreements and of the statutory requirements and consequences of which the District Court speaks; but to presume such knowledge, as just indicated, on the part of a dress fitter entrusting her meager life savings to a stock brokerage firm upon the prodding of its vice-president, and equating her status with that of large institutional investors, is legally as well as logically untenable.

If one can speak of any reliance at all, as mentioned in the District Court's opinion, it was reliance, not caused by the acts of Mrs. Grossmann, but rather by the deceitful practices of Weis, Voisin, Cannon, Inc., through its vice-president who, in blatant contravention of the most basic principles of the common law, and in gross disregard of the provisions of the Federal and Illinois Securities Laws, fraudulently prevailed upon Mrs. Grossmann to entrust her life savings to it. The New York Stock Exchange, instead of disapproving the transaction, participated in that improper scheme; it approved an application in which a widow working as a fitter for her livelihood, upon the prodding of Weis, Voisin, Cannon, Inc., stated in her application that her total financial worth was \$30,000.00, which included her furniture, a profit-sharing plan in the store for which she worked, and money in a checking account. To approve, upon such a flimsy basis, the taking of Twenty-Thousand Dollars (\$20,000.00) (two-thirds of the widow's alleged total assets) as a subordinate debenture loan, was not only morally reprehensible, but also, and above all, illegal.

Thus, the decision of the District Court that a presumption of reliance on the part of Weis Securities' customers and general creditors will bar the claims of a defrauded claimant is, with respect to Mrs. Grossmann, clearly unmerited by the facts and the law.

It must be kept in mind, as repeatedly mentioned, that as far as the sum of \$15,000 is concerned, which was first turned over by Mrs. Grossmann to Weis, Voisin, Cannon, Inc., no valid subordinate debenture agreement had come into existence since Mrs. Grossmann was neither made aware of such an agreement nor did she understand its character and import. Regarding the \$5,000 later turned over by her to Weis, Voisin, Cannon, no subordinate debenture certificate was ever issued to her and the firm's letter acknowledging the receipt of the money merely spoke of crediting the amount to her debenture account without mentioning anything of a *subordinated* debenture account. But even more importantly, no new certificate was ever issued to her when her investment was renewed and, above all, when Weis, Voisin, Cannon's business was taken over by Weis Securities, Inc., without any notification to her. Surely, it cannot be seriously contended that she had a subordinate lending agreement with a firm of whose existence she did not even know. Under these circumstances, even if Mrs. Grossmann's claim is viewed most favorably from the Trustee's standpoint, she must, at the very least, be classified as a general creditor of the bankrupt or as a customer of the debtor under the provisions of Section 6(c)(A)(ii) and (iii) of the SIPA, as will be pointed out later on.

C.

The Transfer Of The Business Of Weis, Voisin, Cannon To Weis Securities Was In Violation Of The Bulk Sales Act.

The transfer of all the assets and property of Weis, Voisin, Cannon to Weis Securities, without notice to claimant, Eva Grossmann, was carried out in violation of the Bulk Sales Acts of both Illinois and New York (Ill.Rev.Stat., ch. 26, secs. 6-101 *et seq.*; N.Y. Laws, ch. 62½, secs. 6-101 *et seq.*), confirming thereby the fact that no subordinate debenture relationship ever came into existence between her and Weis Securities. The purpose of the Bulk Sales Act lies in the prevention of a debtor from suddenly disposing of substantially all his assets without notifying his creditors. One of the primary requirements of these acts is that personal notice be given each creditor so that the creditor may take steps to protect himself against the sale. *United States v. Goldblatt Bros., Inc.*, 128 F.2d 576 (7th Cir. 1942).

Mrs. Grossmann was given no notice of any transaction between Weis, Voisin, Cannon and Weis Securities. In fact, the first notice she received of the transfer was in a letter dated April 27, 1973, from Weis Securities, seeking to confirm her account for purposes of an audit. However, Mrs. Grossmann was clearly a creditor who was entitled to notice prior to the transfer. The term creditor has been construed broadly to include creditors of every class, without limitation (*United States v. Goldblatt Bros., Inc.*, 128 F.2d at 579) and the term encompasses within its purview a holder of a fraudulently induced subordinate debenture agreement.

Section 6-105 of the Illinois Bulk Sales Act, as well as the New York Bulk Sales Act, clearly states that any bulk transfer which is made in violation of the notice requirements is ineffective against any creditor of the

transferor. Section 6-106 outlines the substantive requirements of the notice to be given and specifies that such notice "shall be delivered personally".

Failure to comply with the terms of the Bulk Sales Act renders the transfer voidable at the option of the creditor. *Corrigan v. Miller*, 338 Ill. App. 212, 86 N.E. 2d 853, 856 (1949). The creditor thus has at his disposal the remedies provided by the general law of fraudulent conveyances, including the right of rescission. Ill. Rev.Stat., ch. 26, sec. 6-104, (S.H.A. ch. 26, sec. 6-104 Comment.)

II.

MRS. GROSSMANN'S FUNDS ARE HELD UNDER A CONSTRUCTIVE TRUST FOR HER BENEFIT.

Under basic principles of common law, the funds which Mrs. Grossmann was fraudulently induced to turn over to the stock broker and which were later taken over by the bankrupt were and are held by the broker and the bankrupt under a constructive trust for Mrs. Grossmann's benefit. Hence, these funds do not constitute assets of the bankrupt's estate and consequently may not be used to satisfy the claims of the bankrupt's creditors. See 9 Am. Jur. 2d *Bankruptcy* § 903, p. 677.

The constructive trust is a law-created device to obtain justice for those who have been the victims of fraudulent or unconscionable practices. One of the instances in which a constructive trust will be imposed involves the misuse of a confidential or fiduciary relationship.

The following statement (37 C.J.S. *Fraud* § 2, p. 213) delineates the instances of a confidential or fiduciary relationship, the abuse of which will lead to the raising of a constructive trust:

A fiduciary relation exists:

Wherever confidence on one side results in superiority and influence on the other side; where a special confidence is reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interest of the one reposing the confidence; where confidence is reposed and accepted, whether the origin is moral, social, domestic, or merely personal; or where a person has knowledge and authority which he is bound to exercise for the benefit of another person.

The breach of the duties imposed by a fiduciary relationship will result in the imposition of a constructive trust upon the assets of the person benefiting from the transaction. This principle has been recognized in numerous cases such as *Grand Trunk Western R. Co. v. Chicago & W. Ind. R. Co.*, 131 F.2d 215, 219 (7th Cir. 1942), in which the Court stated:

Again in *People v. Central Mfg. Dist. Bank*, 306 Ill. App. 15, 28 N.E.2d 154, 156, the court made this pronouncement: "A constructive trust may be defined as the device used by chancery to compel one who unfairly holds money or property to convey such money or property to another to whom it justly belongs. When a court of equity finds a defendant is holding money or property which it acquired by unjust, unconscionable or unlawful means, it will raise a trust and take such interest from the defendant and vest it in the wronged party. Any transaction may be the basis for creating a constructive trust where for any reason the defendant holds funds which in equity and good conscience should be possessed by the plaintiff. * * *"

And in *Housewright v. Steinke*, 326 Ill. 398, 403, 404, 158 N.E. 138, 141 (1927), the Illinois Supreme Court declared:

Where two persons stand in such relationship that confidence is necessarily imposed by one in the other and an influence which naturally grows out of

that confidence is abused while such confidence continues or an advantage is obtained by reason of such influence over the confiding party, the person seeking such advantage will not be permitted to retain the same although the transaction could not have been impeached if no such confidential relation had existed. This is true regardless of the existence of actual fraud, undue influence, or coercion. Courts will indulge in the presumption that all transactions between parties occupying confidential relations to each other by which one obtains an undue advantage of the other are fraudulent. (*Crossman v. Kiester*, 223 Ill. 69.)

* * * *

A constructive trust arises where a person clothed with some fiduciary character, by fraud or otherwise, gains something for himself. If a person obtains the legal title to property by virtue of a confidential relation and influence, under such circumstances that he ought not, according to the rules of equity and good conscience as administered in chancery, to hold and enjoy the beneficial interest of the property, courts of equity, in order to administer complete justice between the parties, will raise a trust by construction, out of such circumstances or relations, and will convert the holder of the legal title into a trustee thereof and order him to execute the trust thereof and order him to execute the trust in such manner as to protect the rights of the defrauded party. Constructive trusts are raised by equity for the purpose of working out right and justice though there was no intention of the party to create such relation, and often directly contrary to the intention of the one holding the legal title. (*Kochorimbus v. Maggos*, 323 Ill. 510.)

It must be stressed in this connection that the disclosure provisions of the Federal Securities Laws emphasize and impose high standards for the protection of innocent investors. In *Securities and Exchange Comm. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 84

S.Ct. 275, 11 L. Ed. 2d 237 (1963), the SEC had instituted an action to obtain a mandatory injunction requiring an investment advisor to disclose insider activity. The action was brought under the Investment Advisors Act (15 U.S.C. § 80b-6(2)), which prohibited an investment advisor from engaging in any practice that operated as a fraud upon a customer. Although the Court denied the injunction in that particular instance, it declared that the Advisors Act reflected a congressional recognition of the delicate fiduciary nature of an investment advisory relationship. 375 U.S. at 191, 11 L. Ed. 2d at 246.

In *Brennan v. Midwestern United Life Ins. Co.*, 259 F.Supp. 673 (N.D. Ind. 1966), 286 F.Supp. 702 (N.D. Ind. 1968) (on merits), the Court recognized that the duties arising in a fiduciary relationship often extended beyond the immediate wrongdoer.

Certainly, not everyone who has knowledge of improper activities in the field of securities transactions is required to report such activities. This court does not purport to find such a duty. Yet, duties are often found to arise in the face of special relationships, and there are circumstances under which a person or a corporation may give the requisite assistance or encouragement to a wrongdoer so as to constitute an aiding and abetting by merely failing to take action. 259 F.Supp. at 681-82.

The words quoted from the previously cited decisions fit precisely the relationship which existed between Mrs. Grossmann and the firm's vice-president and Weis, Voisin, Cannon, respectively. Mrs. Grossmann sought the advice of Mr. Meiselman; she relied upon his superior knowledge in financial and investment matters; she reposed her confidence in him because of that knowledge, and trusted him, convinced that he would act in her best interests and not primarily and foremost

for his and his principal's benefit. Due to his knowledge in matters of finance he had a decided advantage and influence over her which he misused and which accrued to the benefit of his principal in whose behalf he acted.

Weis Securities, the successor of Weis, Voisin, Cannon, stands in the latter's shoes, having taken the title from Weis, Voisin, Cannon, subject to its inherent infirmities. The Trustee's interest, in turn, is encumbered with the same defects, for it is well recognized that:

a Trustee in Bankruptcy can have no interest in property acquired by the fraud of a bankrupt, or anyone else, as against the claim of the rightful owner of such property. Cf. Collier on Bankruptcy. 14th Ed., Vol. 3, § 60.18. 'Creditors have no right to profit by the fraud of a bankrupt, to the wrong and injury of the one defrauded.' 9 Am. Jur. 2d, § 903, p. 667 (sic! p. 677).

Nicklaus v. Bank of Russellville, 336 F.2d 144, 146 (8th Cir. 1964).

As previously shown, Weis, Voisin, Cannon, and Weis Securities, as successor of the former corporation, held the monies received from Mrs. Grossmann under a constructive trust. The funds deceitfully taken from her were kept by Weis Securities ostensibly in a separate account. That appears clearly from the letter of Weis Securities to Mrs. Grossmann as late as April 27, 1973, a few weeks before the commencement of the liquidation proceedings, in which Weis Securities asked for confirmation by her of her debenture account with the brokerage firm (GA 11, A 151). Given the separate account, Mrs. Grossmann's funds are identified by that separate account and can be traced into it. *People ex rel. Nelson v. Illinois Bank & Trust Co. of Benton*, 290 Ill.App. 521, 8 N.E.2d 953 (1937); *People ex rel. Nelson v. Rochelle Trust & Savings Bank*, 275 Ill.App. 583 (1934). Yet, even if Weis Securities has commingled these funds with its own funds or those of other persons, Mrs. Grossmann is

entitled to either a portion of the commingled fund proportioned to her contribution thereto, or may assert an equitable lien on the entire fund for the amount of her money. *Marcus v. Otis*, 168 F.2d 649 (C.C.A.2d 1948), *reaff'd*, 169 F.2d 148 (1949); *In re Blue Bird Appliance Co.*, 292 F. 127, 128 (C.C.A.8th 1923); *Primeau v. Granfield* (Decision by Judge Learned Hand), 184 Fed. 480 (S.D.N.Y. 1911), *rev'd on another ground*, 193 Fed. 911 (C.C.A.2d 1911), *cert. den.* 225 U.S. 708 (1912), *Erie Trust Company's Case*, 326 Pa. 198, 191 A. 613 (1937); *Burket v. Bank of Hollywood*, 9 Cal.2d 113, 69 P.2d 421 (1937); *In re Oatway*, [1903] 2 Ch. 356; Rest. Restitution § 209.

III.

THE BROKER ACTED FRAUDULENTLY IN CONTRAVENTION OF PERTINENT FEDERAL AND STATE LAWS.

Weis, Voisin, Cannon, which induced Mrs. Grossmann to purchase the securities in question, acted not only unlawfully by misusing the confidential relationship which existed between its agent and Mrs. Grossmann, but also by engaging in fraudulent practices in violation of applicable federal and state statutes.

The New York Stock Exchange, under whose control Weis, Voisin, Cannon, operated, promulgated a "Know Your Customer Rule", Rule 405 (set forth at GA 55a), which requires members to "learn the essential facts relative to every customer" or "margin account" and "to supervise diligently all accounts handled by registered representatives". This rule was adopted by the Exchange as a prerequisite to its registration pursuant to Sections 6 and 19 of the Securities Exchange Act of 1934 (15 U.S.C. secs. 78f and 78s). The SEC issued a comparable rule, Rule 15b10-3, that applies to broker-dealers who are not members of an exchange.

Failure to enforce these "suitability" rules was held to be actionable. The court in *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith*, 410 F.2d 135 (7th Cir. 1969), ruled that violation of Rule 405 by a member-broker will give rise to an implied civil action for damages as constituting a violation of Section 6 of the Exchange Act of 1934.

Allegations of the breach of Exchange Rules were again held to confer jurisdiction under the Exchange Act in *Starkman v. Seroussi*, 374 F.Supp. 518 (S.D.N.Y. 1974), in which the court stated:

So, too, Rule 405, here alleged to have been violated by Shearson, is precise and has among its purposes protection of the customer qua customer. The rules here allegedly violated may be considered "an integral part in SEC regulation" in furtherance of the purpose declared in section 6(d) to "insure fair dealing and to protect investors". The defendants in their special relationship to plaintiff impliedly represented they would deal fairly and competently with him. The argument may be made that the agreements signed by Seroussi constituted a misrepresentation to the plaintiff that they were entirely proper and not in violation of any rule of the Stock Exchange and indeed were part of a scheme or device to evade the Stock Exchange rules and thereby defraud plaintiff by inducing him to use his margin account to purchase the Leasco warrants. The alleged violations of the Exchange rules are such an integral part of the transaction as to constitute a sufficient claim for violation of sections 6 and 19 of the Exchange Act.

Plaintiff's allegations, which specify the details of violations of the Stock Exchange rules by the defendants, are by no means "immaterial" or "insubstantial" and upon their face are sufficient to confer jurisdiction under section 27 of the Exchange Act. 377 F. Supp. at 524

Additionally, the SEC in Securities Act Release No. 5215, Exchange Act Release No. 9412 [1971 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 78, 455 (Dec. 9, 1971) expressed its concern regarding the efforts by broker-dealers to persuade prospective customers "to subordinate their securities accounts to the claims of other customers and the general creditors of such broker-dealers." It cautioned broker-dealers that the solicitation of account subordinations "may also result in violations of the anti-fraud provisions of the Securities Act and the Exchange Act, and of the regulations thereunder. The anti-fraud provisions of the Federal securities laws, including Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, make it unlawful, in connection with the purchase or sale of a security, to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, or to make untrue statements of any material facts, or to omit any fact necessary to make the statements made not misleading, or to engage in other fraudulent and deceptive practices."

Since the practices of Weis, Voisin, Cannon were clearly violative of the "suitability" rules as well as other rules issued to protect investors, promulgated under applicable federal law, Mrs. Grossmann, as the defrauded party, may, as one of the remedies available to her, rescind the transaction into which she was induced to enter.

It must be kept in mind that all laws promulgated for the protection of the securities investor are *in pari materia* and must be read together. Section 16 of the Securities Act of 1933 (15 U.S.C. § 77p) declares expressly that the rights and remedies provided in the statutes dealing with the protection of security investors

and holders "shall be in addition to any and all other rights and remedies that may exist . . . at law or in equity". It needs not any elaboration that a person, such as Mrs. Grossmann, fraudulently induced by a broker to part with her money in violation of the "suitability" rules cannot be deprived of her right to rescission in such a summary fashion as has been attempted to be accomplished by the District Court in pursuance of the Trustee's contentions.

Moreover, the practices engaged in by the stock broker in the present case were also violative of pertinent Illinois State Statutes. Under section 18 of the Securities Act (15 U.S.C. § 77r) state authorities may exercise concurrent jurisdiction with the federal authorities; hence the provisions of the Illinois Securities Law are equally applicable with regard to the activities of Weis, Voisin, Cannon in Chicago. See *Crosby v. Weil*, 382 Ill. 538, 48 N.E.2d 386 (1943); and *Travelers' Health Ass'n. v. Comm.*, 188 Va. 877, 51 S.E.2d 263 (1949), *aff'd.* 339 U.S. 642, 70 S.Ct. 927, 94 L.Ed. 1154. The Illinois Securities Law of 1953 (Ill. Rev. Stat., ch. 121½, secs. 137.1-137.19) and Section 12 thereof, (Ill. Rev. Stat., ch. 121½, § 137.12) provides in pertinent part:

It shall be a violation of the provisions of this Act for any person:

* * *

F. To engage in any transaction, practice or course of business in the sale or purchase of securities which works or tends to work a fraud or deceit upon the purchaser or seller thereof;

G. To obtain money or property through the sale of securities by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading;

* * *

I. To employ any device, scheme or artifice to defraud in the sale of any securities. 1953, July 13, Laws 1953, p. 1329, § 12; 1955, July 6, Laws 1955, p. 1030, § 1.

In interpreting the statute, the courts have held that its provisions must be liberally construed to protect the investing public from fraud and deceit in the sale of securities. See *Hidell v. International Diversified Instruments*, 520 F.2d 529 (7th Cir. 1975). Every sale made in violation of the Illinois Securities Law is subject to rescission at the election of the purchaser and in accordance with the Act (Ill.Rev.Stat., ch. 121½, sec. 137.13).

Finally, section 2 of the Illinois Consumer Fraud Act (Ill.Rev.Stat., ch. 121½, sec. 262) declares "unfair or deceptive acts or practices, including but not limited to the use or employment of any deception, fraud, false pretense, false promise, misrepresentation or the concealment, suppression or omission of any material fact", with intent that others rely thereon, unlawful. Section 7 of the Act (Ill.Rev.Stat., ch. 121½, sec. 267) provides that the Attorney General may seek injunctive relief and the courts have authority to grant any necessary relief. The Consumer Fraud Act authorizes the filing of an individual suit for relief which obviously encompasses an action for rescission. See *Rice v. Snarlin, Inc.*, 131 Ill. App.2d 434, 266 N.E.2d 183 (1970).

It needs not much imagination that the failure of the broker to inform Mrs. Grossmann, a financially unsophisticated widow, of the precarious nature of the security sold to her and her reliance upon him, amounted to the "concealment" or "omission" of a "material fact" relied upon by her, hence a violation of the Illinois Consumer Fraud Act, entitling her to rescission of the transaction. It must be reiterated that

Mrs. Grossmann cannot be deprived of that right by so summary a procedure as visualized and countenanced by the District Court.

IV.

THE TRUSTEE IS ESTOPPED FROM DENYING MRS. GROSSMANN'S RIGHT TO FULL RECOVERY.

A.

The Trustee Stands In The Broker's Shoes.

Contrary to the District Court's opinion which attempts to impose an estoppel upon Mrs. Grossmann, the victim of a fraud, it is the Trustee who is estopped from denying Mrs. Grossmann's right to full recovery. Under a generally recognized principle of law, a Trustee in Bankruptcy proceedings—and that principle applies equally to liquidation proceedings under SIPA—takes the bankrupt's property subject to all valid claims, liens and equities. *See* 9 Am.Jur.2d, *Bankruptcy* § 903, p. 677.

The Trustee, thus, stands in the bankrupt's shoes and has no better title than the bankrupt Weis Securities, the successor of Weis, Voisin, Cannon, which is tainted with the fraudulent practices engaged in by its predecessor in interest and is privy to it. Tainted with its predecessor's fraudulent practices, Weis Securities could not have raised an estoppel against Mrs. Grossmann since such defense would have presupposed clean hands and lack of wrongdoing. The Trustee standing in the wrongdoer's shoes is afflicted with the same legal malady, hence cannot take refuge behind the cloak of estoppel.

Principles of contract law which allow rescission of an agreement entered into by fraud are not circumvented by the intervention of bankruptcy. Once fraud is established, bankruptcy does not bar the return of proper-

ty which passed under the fraudulent agreement. 4A Colliers on Bankruptcy, par. 70.41, pp. 483-84 (14th ed. 1976).

The raising of an estoppel on the part of the Trustee with respect to Mrs. Grossmann's claim is particularly improper and incongruous since the equitable doctrine of estoppel is based upon principles of justice and fair dealing and derives from equitable tenets and the equities in the case. Hence, only an innocent party may invoke the doctrine, and a party may not raise estoppel to find protection from his own wrongdoing. *General Stencils, Inc. v. Chiappa*, 18 N.Y.2d 125, 219 N.E.2d 169 (1966).

It is characteristic that the Trustee, for the purpose of the motion for summary judgment, has admitted that the Debtor has engaged in fraudulent practices. How then may he, under these circumstances, seriously invoke estoppel on his behalf?

For the Trustee to take the position that repudiation of a subordination agreement, even if fraudulently induced, would decrease the size of the Debtor's estate and have a detrimental impact on the claims of the general creditors, means, in effect, that the general creditors should be enriched at the expense of the defrauded claimant and be allowed to satisfy their claims out of assets which do not belong in the bankrupt's estate.

B.

The Trustee Acting In Part In The Interest Of The Stock Exchange Is Estopped From Raising The Defense Of The Net Capital Requirement.

The Trustee's position and thereby that of SIPC is particularly anomalous in the present case if it is kept in mind that SIPA, under which the present liquidation

proceedings are conducted, has been designed to protect and safeguard the rights of the small investor. SIPC carried out its functions in the instant case through the New York Stock Exchange, a self-regulatory organization, in accordance with the Act. Yet, as previously mentioned, it was the New York Stock Exchange—the agent and enforcing arm of SIPC—which greatly neglected its duties to protect small investors and approved the issuance of subordinated debentures to a widow for \$15,000, or \$20,000, when her total assets (car, small amount of cash in a checking account, etc.) amounted to \$30,000.

The Exchange, instead of enforcing its "Know Your Customer Rule", approved the application which Mrs. Grossmann was induced to sign, committing \$20,000, or two-thirds of her entire net worth, to the purchase of subordinate debentures. The mere reading of the application submitted by Weis, Voisin, Cannon, for approval of Mrs. Grossmann's subordinate status, must have indicated to the Exchange, if it had only cursorily fulfilled its duties, that this investment was totally improper and unsuited to a person in her financial position. Additionally, the Exchange knew that these subordinate debentures were issued to allow Weis, Voisin, Cannon, to meet the net capital requirements which it imposed on its members, yet, the Exchange made no effort whatsoever to inform Mrs. Grossmann of the nature of her investment or to supervise the broker's dealings with her.

It therefore ill behooves SIPC, The New York Stock Exchange and the Trustee, who are supposed to act within the spirit of the Act, to use the wrongful and improper activities of the bankrupt as well as the New York Stock Exchange, and thereby SIPC, as a sword to defeat the victimized small investor rather than a shield to protect and help the victim in the recovery of her just due.

Hence, the Trustee operating under the authority of the SIPC and thereby indirectly the New York Stock Exchange, is estopped from raising defenses which are attributable to the neglect of duties on the part of the Stock Exchange—an arm of the SIPC—in protecting the rights and interest of Mrs. Grossmann.

V.

SIPA MUST BE LIBERALLY INTERPRETED IN FAVOR OF THE INVESTOR.

A.

History And Purpose Of SIPA.

The House Report relating to the SIPA bill—it was the House bill version which became the law—stated expressly that “[t]he primary purpose of the . . . bill [was] to provide protection for investors if the broker-dealer with whom they are doing business encounters financial troubles.” H.R. No. 91-1613, 91st Cong., 2d Sess. (U.S. Code Cong. & Adm. News 5254, 5255). The report stressed that failures of brokers would “lead to loss of customers’ funds and securities with an inevitable weakening of confidence in the U.S. security markets” and “[s]uch lessened confidence” would have “an effect on the entire economy.” (Id.)

SIPA constitutes a link in the chain of federal and state statutes which are designed to protect the securities investor from fraudulent and unconscionable practices of purveyors of securities in all aspects. SIPA expressly states that the provisions of the Securities Exchange Act of 1934 (15 U.S.C. §§ 78a *et seq.*) apply as if SIPA “constituted an amendment to and was included as a section of such Act” (§ 2). Hence SIPA is *in pari materia* not only with the Securities Exchange Act but also the Securities Act of 1933 (15 U.S.C. §§ 77a *et seq.*), particularly since debentures are defined as securities

under the provisions of the latter Act (15 U.S.C. § 77b(1)] and therefore partaking in the statute's protective measures. It is, therefore, axiomatic that the broad protective purpose which forms the essence of the Securities Act of 1933 and the Securities Exchange Act of 1934 applies equally to the provisions of SIPA. This principle has been repeatedly enunciated, and it suffices in this respect to point to the words of the U.S. Supreme Court that securities legislation enacted "for the purpose of avoiding frauds" must be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195, 84 S.Ct. 275, 285, 11 L.Ed.2d 237 (1963).

SIPA, under which the present liquidation proceedings are conducted, has been designed to protect, in particular, the small investor. This is apparent from the Act's provisions creating a fund for the purpose of satisfying customers of the bankrupt broker under certain circumstances up to \$50,000 (§ 6(f)(1)), and in some instances up to \$20,000 only (§ 6(f)(1)(A)). These provisions must be read together with those of section 12 of the Securities Act of 1933 (15 U.S.C. § 77c) which recognizes the investor's right of rescission, as well as those in section 16 of the Securities Act (15 U.S.C. § 77p), declaring that the rights and remedies provided for in that statute "shall be in addition to any and all other rights and remedies that may exist at law or in equity." Thus, all these statutes must be construed "as a harmonizing text of outlawry" (Mr. Justice Frankfurter in *United States v. Hutcheson*, 312 U.S. 219 at 231, 61 S.Ct. 463, 85 L.Ed. 788 at 793 (1941)) of fraudulent or unconscionable practices engaged in by brokers vis-à-vis small investors seeking the brokers' advice and aid in financial matters.

Congress enacted the SIPA of 1970 to alleviate the serious and persistent financial problems which beset the securities industry in 1969-70. The legislative history of the Act reveals that the purpose of the Act has been the protection of customers of securities broker-dealers from losses resulting from insolvency or financial instability of the broker dealers. (H.R. No. 91-1613, 91st Cong., 2d Sess. (1970) (US Code Cong. & Adm. News 5254). An equally important purpose has been the stemming of the growing loss of confidence of public investors in the ability of the securities industry to protect customers' accounts and the elimination of risks which have led to customer losses. *Securities and Exchange Comm. v. Packer Wilbur & Co.*, 362 F. Supp. 510 (S.D. N.Y. 1973), *aff'd*, 498 F.2d 978 (2d Cir. 1974).

To accomplish those purposes the SIPA requires the creation of a fund (§ 4(a)(1)) which will reimburse customer claims of an insolvent broker, to the extent that the broker's assets are insufficient, up to \$50,000 per customer (§ 6(f)(1)). The fund is administered by the SIPC, a non-profit corporation whose members are all broker-dealers registered under the Securities Exchange Act of 1934 and are all generally, members of national securities exchanges. The basic source of the fund is member assessments (§ 4(c)) and transfers from an existing New York Stock Exchange Trust Fund (§ 4(e)(1)).

It is clear from the purpose of the SIPA, as reflected in its legislative history, that it is designed to protect innocent investors from the insolvency of broker dealers. An uninformed investor such as Mrs. Grossmann, who places her entire savings in the hands of a broker and relies on his advice in choosing an investment is clearly the sort of person whom the SIPA was designed to protect. If, through no fault of the customer, the broker

induces the customer to purchase subordinate debentures, which amount to a loan to an already shaky brokerage business, instead of securities in a separate business, the customer has taken no knowing step to alter his or her standing as a customer.

Although the SIPA and cases construing it have indicated that capital contributors are not "customers" within the meaning of the Act the cases do not foreclose a defrauded customer, who knowingly becomes a capital contributor, from being accorded like status as a customer. Section § 6(c)(A)(ii) which excludes claims by persons whose claimed property "by contract, agreement, or understanding, or by operation of law . . . is part of the capital of the debtor" does not address itself to the situation where such an agreement has been fraudulently induced and is, therefore, illegal.

B.

Mrs. Grossmann Must Be Considered A Customer Within The Purview Of SIPA.

It is undisputed that Mrs. Grossmann has a legitimate claim, and it is clear from the nature of the circumstances that it is a claim which Congress intended to protect under the SIPA. It is axiomatic that all statutes are to be construed in a manner implementing the true spirit and intent of the legislature. When a literal reading of a statutory provision produces a result which is at variance with the policy of the legislation as a whole, it is the purpose of the statute that is controlling. *United States v. American Trucking Associations*, 310 U.S. 534, 543-544, 60 S.Ct. 1059 84 L.Ed. 1345, 1351 (1940). A proper construction of the SIPA in a manner which implements its true purpose and intent must inevitably lead to the conclusion that Mrs. Grossmann is within the scope of protection which the Act is designed to afford.

While there is no constitutional requirement that Congress either protect persons who deal with a security broker-dealer or even regulate securities at all, Congress has recognized the need to do so. In *Securities and Exchange Comm. v. Capital Gains Research Bureau*, 375 U.S. 180, 201, 84 S.Ct. 275, 11 L.Ed. 2d 237, 252 (1963), the Court noted that public confidence in the securities industry is essential to the economic health of our nation. In House Report No. 91-1613 (U.S. Code Cong. & Adm. News 5254) the same thought was articulated.

These statements point out that the major problem to which the SIPA addressed itself was the lack of confidence of the public in our national securities markets and the deleterious effect that this public apprehensiveness engendered with respect to our entire economy. It has long been recognized that the way to restore and maintain this confidence has been a concerted effort to protect the private investor.

The securities industry is highly regulated, and the SIPA is part of a series of Acts and regulations aimed at eliminating certain abuses which contributed to the stock market crash of 1929 and the Depression of the 1930s. *Securities and Exchange Comm. v. Capital Gains Research Bureau*, *supra*, at 375 U.S. 186, 84 S.Ct. 275, 11 L.Ed.2d 243. Congress recognized that federal legislation, industry regulations and exchange regulations provided some essential safeguards, but that additional protection of persons dealing with broker-dealers was necessary to instill and preserve the public confidence which was essential to our economy (H.R. No. 91-1613, *supra* at U.S. Code Cong. & Adm. News 5256).

The SIPA emphasizes rather than diminishes the regulatory duties created by federal legislation, industry and exchange regulations, and, together with the other security regulations, creates a comprehensive program

designed to protect private investors in general, and innocent, unsophisticated, private investors in particular.

This program operates on two levels. On the first level the SEC and the NYSE are charged with the duty of protecting investors by regulating the operations of brokers. Their "know your customer" rule is supposed to prevent brokers from inducing unsophisticated small investors to invest a large portion of their total assets in investments which are speculative and/or not adequately secured. It is an integral part of SEC regulation. *Starkman v. Seroussi*, 377 F.Supp. 518, 524 (S.D. N.Y. 1974). (See also SIPA § 9).

If those charged with the duty of enforcing the above mentioned statutes and regulations fail to protect an investor by enforcing them properly, and this failure results in a loss to the investor, the second level of protection which is created by the SIPA comes into operation. On the second level the SIPA establishes a type of insurance fund which is similar in purpose and operation to the fund administered by the Federal Deposit Insurance Corporation (FDIC). H. R. No. 91-1613, *supra* at 5255. Just as the FDIC guarantees depositors in banks that if those agencies which regulate the banks are unable by their controls to maintain the solvency of the bank, the FDIC will, out of its fund, pay the depositors up to its statutory limit, the SIPA guarantees investors that if those charged with the duty of regulating the operations of broker-dealers fail to do so in a manner which protects private investors, the SIPC will, out of its fund, reimburse investors up to the statutory limit.

The District Court Opinion which is predicated on the erroneous premise that Mrs. Grossmann was a "subordinate lender" begs the question rather than addresses the merits of her claim. At no point did Mrs. Grossmann

intend to become a "subordinate lender". In fact she did not even know the meaning of "subordinate lender" or a subordinate debenture holder.

While the District Court does not specifically reach the question of whether Mrs. Grossmann is a "customer" or "cash customer," implicit in its characterization of her as a "subordinate lender" and its holding that her claim is foreclosed by the claims of the general creditors is its determination that she is not a person whom Congress intended to protect under the SIPA. This holding is apparently based on a strict, literal interpretation of section 6(c)(2)(A)(i); it renders the Act anemic and makes its intended protection as visualized by Congress, illusory. *United States v. American Trucking Association, supra*, at 310 U.S. 543-544, 60 S.Ct. 1059, 84 L.Ed. 1351.

Rather, it appears that if the facts in the record are carefully examined, Mrs. Grossmann can well be classified as a "customer" within the definition of Section 6(c)(2)(A)(ii)(VI) of the Act (15 U.S.C. 78fff(c)(2)(A)(ii)). It was repeatedly stated that she had no idea that she had purchased subordinate debentures or what the meaning or characteristics of such debentures were; nor did she know, up to the last weeks before the institution of the present proceedings, that her funds were allegedly held by Weis Securities. Under these circumstances, the definition of "customer" who is a person having "claims against the debtor arising out of . . . conversion of . . . securities", or even more appropriately, a "person who has deposited cash with the debtor for the purpose of purchasing securities" applies properly to Mrs. Grossmann if the purpose and intent of the Act are kept in mind and the admonition of the U. S. Supreme Court heeded that securities legislation enacted to avoid fraud must be interpreted "not technically and restrictively,

but flexibly to effectuate its remedial purposes". *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 195.

It should be emphasized that treatment of Mrs. Grossmann as a "customer" under SIPA in the present liquidation proceedings would in no way diminish the insurance protection of other customers, since, to the extent that the Debtor's assets are insufficient to satisfy all customers' claims, SIPC will advance to the Trustee such sums from its fund as would be necessary to provide for prompt payment of customers' claims, in this instance \$20,000, which constitutes the limit for a customer's cash claim (§ 6(f)(1)(A)); Mrs. Grossmann's claim exactly accords with that limit.

It might be mentioned in this connection that, as previously pointed out, the Trustee's position in the present case seems, as far as Mrs. Grossmann's claim is concerned, somewhat strange and incongruous. His primary function envisaged by the legislation from which he derives his authority is to safeguard and protect the interests of the investors who have suffered through the insolvent broker's practices and machinations; yet he fights those interests tooth and nail. Even stranger is the attitude of the SIPC and its operating and enforcing arm, the New York Stock Exchange, since these agencies were supposed to protect the small investor, such as Mrs. Grossmann, in order to restore the public's confidence in the stock brokerage business. Could it be that SIPC, as well as the New York Stock Exchange, are motivated in their attitude by a desire to protect their purse strings and those of their constituent brokers, since they have to advance to the Trustee out of a fund maintained by the brokers the necessary money, up to a \$50,000.00 limit per customer,

to satisfy the customer's claims? Yet, such attitude obviously violates the basic purpose and spirit of the Act and, it is respectfully submitted, should not be tolerated and impressed with the Court's seal of approval.

CONCLUSION

For all the aforementioned reasons it is respectfully asked that this Court reverse the order of the District Court and remand the case to the Bankruptcy Judge with the direction to order the Trustee to pay Mrs. Eva Grossmann's claim of \$20,000. in full out of the Debtor's estate or out of funds advanced to the Trustee by the Securities Investor Protection Corporation, and that the costs of these proceedings be assessed against the Debtor's estate, the Securities Investor Protection Corporation, and the New York Stock Exchange.

Respectfully submitted,

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APPENDIX

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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In the Matter : 73 Civ. 2332

of : PETITION ON BEHALF OF
EVA GROSSMANN.

WEIS SECURITIES, INC., :
Debtor.

- - - - -x

NOW COME THE PEOPLE OF THE STATE OF ILLINOIS
ex rel WILLIAM J. SCOTT, the Attorney General of the State of
Illinois, and, in behalf of EVA GROSSMANN, a citizen and resi-
dent of the State of Illinois, respectfully petition this Honorable
Court as follows:

1. EVA GROSSMANN is a citizen and resident of the State
of Illinois. She is a foreign born widow. After having spent the
greater part of the war years during the Second World War as a
slave laborer in German concentration camps, she came to this
country in 1947.^o From that time on she worked, with the excep-
tion of a short intermission, continuously as a fitter for Chas. A.
Stevens Co. in Chicago, Illinois, where she is still employed.
2. In 1967, after her husband's death, she was induced by the
husband of one of the store's customers, at which she was working,
to put all her savings in subordinate debentures of Weis, Voisin,

Cannon, Inc. The man who induced her to place her savings in those subordinate debentures was Leo Meiselman, Executive Vice President of Weis, Voisin, Cannon, Inc.

3. In accordance with the aforementioned inducement, a debenture was issued to Mrs. Grossmann by Weis, Voisin and Cannon, in the amount of \$15,000.00 on the 28th of June, 1967, denominated as a two year Debenture Bond. A copy of a letter of Weis, Voisin, Cannon, Inc., dated June 29, 1967, as well as a copy of the bond are herewith attached to this Petition as Exhibit A and B, respectively, and made a part hereof. In a letter, dated July 2, 1969, addressed to Mrs. Grossmann, Weis, Voisin, Cannon, Inc. acknowledged receipt from Mrs. Grossmann of a check in the amount of \$5,000.00 for Mrs. Grossmann's Debenture Account; a copy of that letter is attached to this Petition as Exhibit C. No Debenture Bond for the amount of \$5,000.00 was ever delivered to Mrs. Grossmann.

4. The debenture bonds in the amount of \$20,000.00 were automatically renewed by Weis, Voisin, Cannon, Inc. without ever having asked Mrs. Grossmann for her approval. See copy of letter of Weis, Voisin, Cannon, Inc. dated June 18, 1969, herewith attached hereto as Exhibit D.

5. By letter dated April 27, 1973, Weis Securities Inc. requested Mrs. Grossmann to confirm her account of Subordinated Debentures in the sum of \$20,000.00. A copy of that letter is herewith attached to this Petition as Exhibit E.

6. At no time did Weis, Voisin, Cannon, Inc. or any of its representatives inform Mrs. Grossmann of the fact that the debentures issued to her were unsecured and subordinated to the claims of other creditors, nor did Mrs. Grossmann have the educational background or the financial capability or sophistication to understand or grasp the import and significance of a subordinated-unsecured debenture.

7. At no time was any advice or information furnished to Mrs. Grossmann that Weis, Voisin, Cannon, Inc. had transferred its business to Weis Securities. Failure to give such information was in clear violation of the Illinois Bulk Sales Act.

8. The failure of Weis, Voisin, Cannon, Inc. to fully inform and advise Mrs. Grossmann regarding the nature of the securities sold to her was not only in violation of the Illinois Securities Act (Ill. Rev. Stat. 1973, ch. 121-1/2, sec. 137.12(F), (G), and (I)), and the pertinent provisions of the Federal Securities and Exchange

Act but also amounted to gross fraud and the breach of a fiduciary duty owed by the broker to the customer.

9. Weis, Voisin, Cannon, Inc. and Weis Securities, Inc.,
acted
having committed such fraud and having/in contravention of the applicable statutes as well as having been guilty of a gross breach of their fiduciary duties, the amount of \$20,000.00 paid by Mrs. Grossmann was unlawfully received and held under a constructive trust by Weis, Voisin, Cannon, Inc. and Weis Securities for the benefit of claimant, EVA GROSSMANN.

10. The claim of EVA GROSSMANN in the amount of \$20,000.00 was allowed in full by the Trustee as a claim subordinate to the claims of creditors of the Debtor.

WHEREFORE, it is respectfully petitioned that this Court order that the amount of TWENTY THOUSAND DOLLARS (\$20,000.00) is held by the Trustee for the liquidation of the business of Weis Securities, Inc., under a constructive trust for the benefit of the claimant, EVA GROSSMANN, and that

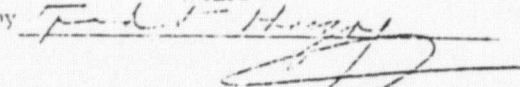
—6a—

said amount be segregated from the estate in liquidation and
paid out in full to claimant, EVA GROSSMANN.

Respectfully submitted,

WILLIAM J. SCOTT
Attorney General of the State of Illinois

by



160 North LaSalle Street Suite 900
Chicago, Illinois 60601 (793-3500)

FRED F. HERZOG
First Assistant Attorney General
160 North LaSalle Street - Suite 800
Chicago, Illinois 60601 (793-2457)
Of Counsel.

—7a—

EXHIBIT A

WEIS, VOISIN, CANNON, INC.

MAIN OFFICE
111 BROADWAY
NEW YORK, N. Y. 10005
WORTH 4-7300

BRANCH OFFICES
MEMBER NEW YORK AND AMERICAN STOCK EXCHANGES
AND PRINCIPAL COMMODITY EXCHANGES
141 W. JACKSON BOULEVARD • CHICAGO, ILL. 60604
WATERS 2-1173

BRANCH OFFICES
60 WEST 42ND AVE. N. Y. C.
CEDARHURST, L. I., N. Y.
CHICAGO, ILL. 60611
NEW HAVEN, CONN.
ENCLERIDGE, N. J.
MAPLEWOOD, N. J.
MIAMI BEACH, FLA.

June 29, 1967

Mrs. Eva Grossman
1050 West Catalpa
Chicago, Illinois 60640

Dear Mrs. Grossman:

We acknowledge receipt of:

Cashier check #099851 drawn on the Chicago Federal
savings and Loan Association payable to Weis, Voisin,
Cannon, Inc. in the amount of \$7,000.00, and

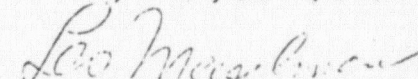
Cashier check #S0417669 drawn on the Uptown Federal
Savings and Loan Association payable to Weis, Voisin,
Cannon, Inc. in the amount of \$8,000.00.

These funds are to be used to purchase two-year
debentures with ninety day notice from our firm, Weis, Voisin,
Cannon, Inc.

Thank you for your cooperation, I am,

Respectfully,

WEIS, VOISIN, CANNON, INC.



Leo Weiselman
Executive Vice President

LM:mek

Encl.

No. 21

\$ 15,000

WEIS, VOISIN, CANNON, INC.

INCORPORATED UNDER THE LAWS OF THE STATE OF DELAWARE

NAME OF REGISTERED OWNER Mrs. Eva Grossmann

WEIS, VOISIN, CANNON, INC., a corporation duly organized and existing under and by virtue of the laws of the State of Delaware, and duly authorized to conduct business in the State of New York (hereinafter called "Corporation") being a member of the New York Stock Exchange, the American Stock Exchange and other principal commodity exchanges, with its principal office at 111 Broadway, New York, N. Y., hereby promises to pay to the registered holder hereof (unless this debenture shall have been duly called for previous redemption and payment) upon presentation hereof on the 1st day of July, 1969, in legal tender of the United States of America, the principal sum of

FIFTEEN THOUSAND

DOLLARS (\$ 15,000.00)

Payments of principal as well as interest, are to be made at the Main Office of the Corporation. Interest on the remaining unpaid balance of principal shall become due at the rate of 8 per cent per annum from the date hereof, such interest being payable quarter-annually on the first day of April, July, October and January of each month in each and every such month following the date hereof.

The registered holder by acceptance of this subordinated debenture agrees for himself, his heirs, executors, administrators and assigns that the obligations of the Corporation under this agreement with respect to the payment of principal and interest are and shall be subordinate in right of payment and subject to the prior payment or provision for payment in full of all claims of all other present and future creditors of the Corporation arising out of any matter occurring prior to the Installment Date, and that, in the event of any receivership, insolvency, bankruptcy, assignment for the benefit of creditors, reorganization, whether or not pursuant to bankruptcy laws, liquidation, or any other marshalling of the assets and liabilities of the Corporation, the holder hereof shall not be entitled to participate or share, ratably or otherwise, in the distribution of the assets of the Corporation until all claims of all other present and future creditors of the Corporation arising out of any matter occurring prior to the Installment Date have been fully satisfied, or provision has been made therefor.

This loan and the various installments thereof hereinabove designated in the repayment schedule, may not be paid in whole or in part prior to the respective Installment Dates there indicated without prior notice to the New York Stock Exchange. If the loan, or any installment thereunder is paid in whole or in part on or prior to the respective Installment Dates and if at the time of any such payment the Corporation shall be insolvent the registered holder agrees irrevocably for himself, his heirs, executors, administrators and assigns (whether or not such registered holder, his heirs, executors, administrators or assigns shall have had any knowledge or notice of such insolvency at the time of any such payment) to repay to the Corporation, its successors and assigns, the sum so paid, for the benefit of all other creditors of the Corporation; provided, however, that any suit for the recovery of any such payment must be commenced within one year of the date of such payment.

The unpaid portion of the obligation of the Corporation hereunder shall forthwith mature, together with interest accrued thereon, in the event of any receivership, insolvency, bankruptcy, assignment for benefit of creditors, reorganization, whether or not pursuant to bankruptcy laws, liquidation or any other marshalling of the assets and liabilities of the Corporation; but payment of the same shall remain subordinate as hereinabove set forth.

Default in the payment of interest or principal shall not accelerate the maturity of the obligation and payment of the obligation shall remain subordinate as hereinabove set forth.

The registered holder agrees that so long as the Corporation continues as a member corporation of the New York Stock Exchange, he will not, without the prior written approval of said Exchange, transfer, sell, assign, pledge or otherwise create, or permit to be created, any lien, charge or encumbrance upon this instrument.

The term "the Corporation", as used in this agreement shall mean Weis, Voisin, Cannon, Inc., or any successor thereto.

This agreement shall be binding upon the registered holder, his, their or its heirs, executors, administrators, successors and assigns.

This agreement shall be effective on the date it is approved by the New York Stock Exchange.

IN WITNESS WHEREOF the parties hereto have set their hands and seals this 28th day of June, 1967.

WEIS, VOISIN, CANNON, INC.

By

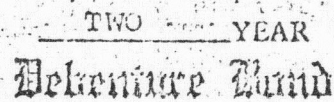
Secretary

(CORPORATE SEAL)

TWO

Year Debenture Bond

5252525 5252525



\$ 15,000

NOTICE:—No writing on this Debiture Bond or entry to be made except by an officer of the Corporation.

[illegible]

NEW YORK
111 BROADWAY
NEW YORK, N.Y. 10006
WO 4-7300



CHICAGO
50 W. ADAMS
CHICAGO, ILLINOIS 60603
641-0500

Mrs Eva Grossmann
5840 N Sheridan Rd
Chicago, Ill.

DATE 7-2-69

ACCT. NO.

WE HAVE THIS DAY (RECEIVED ☐ DELIVERED ☐) FOR YOUR ACCOUNT. (☐ CREDIT ☐ DEBIT) YOUR ACCOUNT.

DESCRIPTION	AMOUNT
Check Received 7-2-69 for Debiture Account of Customer	\$5,000.00
Check and receipt to be sent to Mr Harold Federbush in New York Office	

WVC-100

WELLS FARGO BANK, INC.

BY _____ Ink

EXHIBIT C

—9a—

EXHIBIT D

WEIS, VOISIN, CANNON, INC.

ESTABLISHED 1917

INCORPORATED IN NEW YORK
AND OFFICES IN NEW YORK, CHICAGO, NEW HAVEN, CONN.,
HARTFORD, CT., MIAMI BEACH, FLA., FORT LEE, N. J.



MAIN OFFICE
111 BROADWAY
NEW YORK, N. Y. 10006
WOISIN 4-7300

BRANCH OFFICES
HARTFORD, CT.
HARTFORD, CT.
630 1/2 ST. & 2ND AVENUE, N.Y.C.
MID TOWN OFFICE
1305 BROADWAY, N.Y.C.
CHICAGO, ILLINOIS
NEW HAVEN, CONN.
ENDEWOOD, N. J.
HARTFORD, N. J.
FORT LEE, N. J.
GOSHURST, N. Y.
HARTFORD, N. Y.
MIAMI BEACH, FLA.

June 18, 1969

Mrs. Eva Grossmann
5840 N. Sheridan Road
Apartment 305
Chicago, Illinois

Dear Mrs. Grossman:

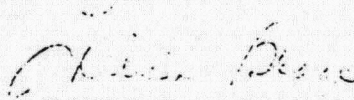
At Mr. Leo Meiselman's suggestion, enclosed is renewal of the Subordinated Debenture which will mature on July 1, 1969.

Please sign the Agreement on the second page and return to me in the enclosed envelope.

Thank you for your continued interest in this Corporation.

Very truly yours,

WEIS, VOISIN, CANNON, INC.


Lillian Brage

L.B:kb
Enclosures:

EXHIBIT E

WELLS FARGO BANK



ONE WUL PLAZA, NEW YORK, NEW YORK 10004 • 212 477-2000

April 27, 1973

Mrs. Eva Grossman
5650 North Sheridan Road
Chicago, Ill 60626

951-1000

Gentlemen:

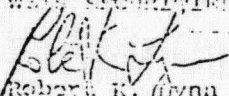
Our auditors, Touche Ross & Co., 1633 Broadway, New York, N. Y. 10019, are making an examination of our financial statements. Please confirm to them our accounts with you as of 4-27-73.

	Receivable from you	Payable to you	TERMS
Open Account			
Notes and Loans			
Subordinated Debentures	20,000		

Your prompt attention to this request will be appreciated. An envelope is enclosed for your reply.

Very truly yours,

WELLS SECURITIES INC.


Robert R. Gynna
Vice President

Confirmation:

The accounts are correct as of the date indicated, except as noted below:

Date

5-7-73


Signature

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

- - - - - X
:
In the Matter
:
of
:
WEIS SECURITIES, INC., 73 Civ. 2332
:
Debtor.
:
- - - - - X

STATEMENT OF MATERIAL FACTS
AS TO WHICH THERE IS A GENUINE ISSUE.

Pursuant to Rule 9(g) of the Local Rules of this Court,
William J. Scott, Attorney General of the State of Illinois, ex
rel. EVA GROSSMANN, submits the following statement of
facts material to the motion for summary judgment as to which
there is a genuine issue of facts to be tried:

1. The circumstances under which Mrs. Eva
Grossmann was induced to invest her life savings in the sum of
Twenty Thousand Dollars (\$20,000) in subordinated debentures
of Weis, Voisin & Cannon, and the manner in which the transac-
tion was executed, including the application supposedly filed by
Mrs. Grossmann with the New York Stock Exchange.

2. The automatic renewal of the debentures by Weis, Voisin & Cannon, without any notification of Mrs. Grossmann.

3. The absence of delivery to Mrs. Grossmann of the \$5,000 debenture.

4. The taking over of Weis, Voisin & Cannon by Weis Securities, Inc., without any notification of Mrs. Grossmann.

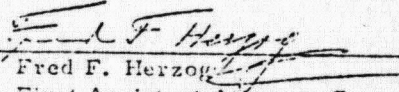
5. The failure of the New York Stock Exchange to properly supervise and control Weis, Voisin & Cannon and Weis Securities, Inc.

6. The time when Mrs. Grossmann learned of the bankruptcy of Weis, Voisin & Cannon and Weis Securities, Inc.

DATED: February 21, 1975

WILLIAM J. SCOTT
Attorney General
of the State of Illinois
ex rel. Eva Grossmann

By: _____


Fred F. Herzog
First Assistant Attorney General
100 North LaSalle Street - Suite 800
Chicago, Illinois 60601
(312) 793-2457

STATE OF ILLINOIS)
) SS
COUNTY OF COOK)

AFFIDAVIT OF EVA GROSSMANN

EVA GROSSMANN, of 5650 North Sheridan Road,
Chicago, Illinois 60660, after having been duly sworn, upon
oath, deposes and says:

1. This affidavit is submitted in opposition to the Trustee's
motion for summary judgment and in support of affiant's claim
herein.

2. I was born in Cluj, Romania, on July 29, 1922. After
having attended the grammar and high schools in Cluj, Romania,
I was taken by the Nazis in 1943 to the infamous concentration
camp in Auschwitz as slave laborer. I remained in that camp
until September, 1943, when I was transported as slave laborer
to a camp in Czechoslovakia, where I worked in a German mu-
nitions factory. I was freed in June, 1944, by the advancing
Russian army. Having returned to Romania, I married in
October, 1947, Ernest Grossmann.

3. After my husband and I had left Romania, we emi-
grated to the United States in 1950. Shortly after my arrival
in Chicago I obtained a job as a fitter in the Charles A. Stevens
Department Store in Chicago, Illinois. With the exception of

two years I have worked continuously on the same job from that time on, and I am still presently employed as a fitter at Charles A. Stevens.

4. My husband, who had worked as a bookkeeper in Chicago, passed away in March of 1967. We both had accumulated savings in the amount of \$15,000. After his death I received, in addition thereto, \$5,000 from a life insurance policy which my husband had taken out for my benefit.

5. One of the customers of the Charles A. Stevens store, whom I regularly fitted, was Mrs. Leo Meiselman. She was aware of the fact that my husband had passed away and during one of the fittings she told me that her husband, who was an official of the Weis, Voisin & Cannon brokerage firm in Chicago, had invested successfully funds for several widows and had helped out other people in their investment problems. She suggested that I get in touch with him. I did so, and told him that I had a total of \$20,000 available for investment purposes, which constituted mine and my husband's life savings. He in turn advised me that I invest first \$15,000 and, later on, an additional \$5,000, in securities of Weis, Voisin & Cannon. He explained to me that this investment was like a loan to the company. He did not mention anything of "subordinated debentures". Even if he had

mentioned that term to me, I wouldn't have understood it, since I didn't know and still don't know what it meant, and what its real significance is. I thought at the time of the investment that these debentures were really nothing else but shares of stock in Weis, Voisin & Cannon, and that I owned stock in the company. I have no knowledge whatsoever of finances or of the stock market, and am not familiar with any financial terms.

4. At the time when Mr. Meischman asked me to invest my savings in the debentures he told me that this would be the best investment for me, since it would pay the highest interest. I relied and acted solely upon his advice and trusted him completely, since he was the expert in a field of which I had no knowledge whatsoever. At the time of the investment he also asked me to make out an application and to show him proof of my citizenship. I don't know and did not ask him to whom and for what purpose the application had to be made out; I simply followed his instructions. I cannot recall today whether he made out the application upon information which I gave him or whether I made it out myself. Upon his prodding, I or he wrote down on the application that my financial worth was \$30,000, which included the value of my furniture, some

money in a checking account for living expenses, some government bonds, and some pieces of jewelry.

7. The debentures in which I had invested my \$20,000 were supposedly automatically renewed; however, to my knowledge, I never received a renewal notice. I also never received a certificate for the additional \$5,000 debenture, which I had bought after the purchase of the \$15,000 debenture, again upon the advice of Mr. Meiselman. I received quarterly checks, first in the amount of 8%, and later in the amount of 9% as interest on the debentures.

8. In 1971, I learned that Mr. Meiselman had left Weis, Voisin & Cannon and, later on, that Weis Securities had taken over the firm of Weis, Voisin & Cannon; I never received any notification of that fact.

9. In 1972, when I once did not receive my quarterly check, I contacted Weis, Voisin & Cannon in Chicago, and was told that a Mr. Raike (I don't know the exact spelling) had taken over Mr. Meiselman's account and that no proof of my debentures could be found on the firm's records in Chicago. However, afterwards I received a phone call from Mr. Raike and he

told me that matter was straightened out; I then received my interest check's again.

10. As previously indicated, I never received any notification of a renewal of the debentures or of the take-over of Weis, Voisin & Cannon by Weis Securities. As I recall, I learned of the bankruptcy of Weis, Voisin & Cannon or Weis Securities through the newspapers in May or June, 1973.

John Goodman

SUBSCRIBED AND SWORN TO
before me this 17th day of
February, 1975.

R. H. [Signature]
Notary Public

CERTIFICATE OF SERVICE

I, Fred F. Hemon, First Assistant Attorney General of Illinois, ex rel Eva Grossmann, hereby certify that on the 21st day of February, 1975, I served copies of the foregoing Statement of Material Facts As to Which There is a Genuine Issue, upon the following persons by depositing a copy thereof in the United States Mails, post paid, addressed to them as indicated below:

Milbank, Tweed, Hadley & McCloy
1 Chase Manhattan Plaza
New York, NY 10005
Att'ys. for New York Stock Exch., Inc.

Hughes Hubbard & Reed
One Wall Street
New York, NY 10005
Att'ys. for the Trustee

Baer & Marks
70 Pine Street
New York, NY 10005
Att'ys. for Fidelity Corp.

Rogers & Wells
200 Park Avenue
New York, NY 10003
Att'ys. for Security Nat'l. Bank

Hahn, Hessen, Margolis & Ryan
350 5th Avenue
New York, NY 10001
Att'ys. for Exchange Nat'l. Bank
of Chicago

Trachtenberg & Winick
500 5th Avenue
New York, NY 10036
Att'ys. for General United Life
Ins. Co., All American Life
& Casualty Co. and Robert Slater

Miller, Singer, Michaelson &
Raives
555 Madison Avenue
New York, NY 10022
Att'ys. for Eva Grossmann

Lipkowitz, Plaut, Salberg &
Harris
1290 Avenue of the Americas
New York, NY 10019
Att'ys. for Arthur J. Krizel
and Ester Levick

Patterson, Belknap & Webb
30 Rockefeller Plaza
New York, NY 10020
Att'ys. for Milton S. Gould

Shea, Gould, Climenko & Kramer
330 Madison Avenue
New York, NY 10019
Att'ys. for Sol Kittay

Stroock, Stroock & Lavan
61 Broadway
New York, NY 10006
Att'ys. for Sol Kittay

Williamson & Schoeman
Suite 2240
60 East 42nd Street
New York, NY 10017
Att'ys. for Jesse Reid Dietz

Michael E. Don, Esq.
900 Seventeenth St. NW - Suite 800
Washington, D. C. 20006
Att'y. for Securities Investor
Protection Corporation

Stackpole & Amidon
P. O. Box 1016
Stowe, VT 05672
Att'ys. for Arthur J. Kreizel

Dickstein, Shapiro & Morin
1735 New York Avenue, N. W.
Washington, D. C. 20006
Att'ys. for Claimants Aldrich et al.

Dunning, Bartholow & Miller
161 East 42nd Street
New York, NY 10017

Robert J. Millstone, Esq.
Special Counsel
Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In the Matter

73 Civ. 2332

-of-

WEIS SECURITIES, INC.,

MEMORANDUM OPINION

Debtor.

Sol Kittay,

Plaintiff

v.

Edward Redington, Trustee,

Defendant

Claims of George D. Aldrich,

et al., Subordinated Lenders.

ROY RABITT, Bankruptcy Judge:

This dispute between the trustee of the debtor (Weis Securities) and subordinated lenders to the debtor arises out of the debtor's financial demise and its subsequent liquidation under the Securities Investors Protection Act of 1970, 15 U.S.C. §§. 78aaa et. seq. (1970 ed.) (SIPA). Proceeding on the assumption that there is no real dispute as to what he perceives to be the controlling and material facts, the trustee has moved for summary judgment, Rule 56, F.R.Civ.P., in his favor, thereby leaving these admitted lenders in the subordinated position, a

status for which they contracted.^{1/}

What is central to this case is the effort by the subordinated lenders to retrace the chronology during which they acquired their inferior financial position, come to a different arrangement in this second try and thereby improve their legal position to share in the distribution of the debtor's assets within the scheme of the SIPA. Not surprisingly the trustee vigorously resists. In short, the subordinated lenders seek rescission of their agreements.

The material facts, at least the historical ones, are not in dispute.

During the period between June 28th, 1967 and May 7, 1973, the subordinated lenders, individually, entered into agreements with the debtor under which loans of cash and/or securities were made to the latter for unrestricted use in its business as a broker-dealer. Each agreement contained express, unequivocal and unambiguous provisions to the effect that in the event of liquidation, the subordinated lender agreed to subordinate his claim for property loaned to the claims of all the other creditors of the debtor and to waive any right to participate in the debtor's assets until the claims of all other creditors were satisfied. Further, each

^{1/}

Whether Bankruptcy Rule 756, 411 U.S. 1084, making Rule 56, F.R.Civ.P., applicable, or the latter controls, is not material. Either provides the procedural linchpin for setting the stage for the unfolding of this controversy.

subordinated lender agreed not to permit the withdrawal of his property without the consent of the debtor and the New York Stock Exchange (the Exchange) at any time the debtor was in financial difficulty, including the difficulty in complying with the so-called "Net Capital Rule" under Exchange Rule 325. 17 C.F.R. § 240.15.^{2/}

The subordination agreements also permitted the broker to freely lend or hypothecate securities loaned without the consent of the particular subordinated lender. Almost all of the securities loaned under the subordination agreements were hypothecated to banks as security for loans prior to the commencement of these liquidation proceedings.

On May 24, 1973, Weis' liquidation was begun in keeping with Section 5(b) (1) of the SFA, 15 U.S.C. § 78e (b) (1) (1970 ed.), for the appointment of a trustee to liquidate the debtor's business.

In a complaint for injunctive relief filed on the same day, the Securities and Exchange Commission (S.E.C.) alleged, inter alia, that certain of the debtor's financial statements were false and misleading, in violation of the provisions of the Securities Exchange Act of 1934, 15 U.S.C. § 78; (b) and Rule X-10 B-5 promulgated thereunder by the S.E.C. The debtor did not contest the issuance of the injunction.

2/

Some of the subordinated lenders claim to have been customers induced by fraudulent misrepresentations into entering subordination agreements on their cash

On or about July 16th, 1974, the subordinated lenders instituted various proceedings against the trustee, the legal effect of all of which would be rescission of the subordination agreements.^{3/} In their application, the subordinated lenders allege substantially the same facts as those contained in the S.E.C. complaint, i.e., false and misleading financial statements made by the debtor to the subordinated lenders to induce the signing of the subordination agreement in violation of the anti-fraud provisions contained in the Securities Exchange Act of 1934 and Rule 10-b-5.

The trustee, insisting that there are no genuine issues of material fact in dispute, invokes Rule 56 of the Federal Rules of Civil Procedure via Bankruptcy Rule 756, see footnote 1, *supra*, and seeks judgment, the essence of which would leave the subordinated lenders exactly where their agreements placed them. The trustee's position is that even conceding the truth of what the subordinated lenders urge, they are estopped, as a matter of law, to rescind because of the reliance placed on the subordinations by other creditors who extended credit.

There is case law in support of both arguments, and both come with not unrespectable title deeds. But the controlling case decided in this circuit is In the Matter of Credit Industrial Corporation, 366 F.2d 402 (2d Cir. 1966).

^{3/}

Some filed complaints seeking to reclaim property, thereby following the adversary proceeding route prescribed by Part VII of the Bankruptcy Rules, 411 U.S.1068, *et seq.*

where the court held that given a lawful and valid subordination agreement, the bankruptcy court is without equitable power to realign the contractual priorities established by the parties in their contract. 366 F.2d at 409.

This result is not mandated, however, where the subordination agreement is unlawful, e.g., induced by fraudulent misrepresentation, and therefore invalid. The court explained that

"When a junior creditor establishes that the subordination agreement is unlawful, it may be reasonable and necessary, if equity is to be done, to require a senior creditor to prove that he relied on the subordination agreement, without actual or constructive knowledge of any infirmity in the agreement, in advancing funds to the bankrupt as a condition to receiving priority in the distribution of the bankrupt's estate." [emphasis added]

To this court, applying equitable principles, the law seems to be that should reliance be established, estoppel would bar rescission of the subordination agreement. But the establishment of reliance is surely a factual issue en route to application of legal estoppel. So much seems to be the import of the language quoted above that "it may be reasonable and necessary" to show reliance.

The trustee insists that proof of reliance would be extraneous in the stock brokerage world where members are subject to the net capital rule. The underlying premise of financial regulation in the securities industry is that the public is entitled to deal with a stockbroker without concern for its financial stability. The Securities and Exchange

Commission imposed and monitors compliance with rules concerning financial responsibility for the express benefit of the investing public and confidence in the securities world. It is inevitable that investors will rely on this regulatory scheme and the mere existence of a net capital rule alone should be sufficient proof of justified investor reliance upon the probity of dealing in securities.

The subordinated lenders contend that reliance upon the subordination agreement is not to be assumed. There is no evidence that most of Weis' creditors were aware of the subordination agreements or of the net capital rule. To the extent that customers did rely at all, it may be assumed that such reliance was on the protection provided by the federal laws regulating the industry. Indeed, if anything, the SIPA offered greater security in dealings between customers and the debtor-broker.

The net capital rule insures liquidity against current customer demands, not security against broker-dealer insolvency. See Study of Unsafe and Unsound Practices, CCH Fed. Sec. L. Rep. Special Studies 74, 801 at 65, 521. The very purpose behind the SIPA was to provide the kind of protection against broker-dealer insolvency which the net capital rule was unable to achieve. Finally, the subordinated lenders contend that it is probable that institutional investors and other large creditors of the debtor were misled into extending credit on the basis of the very same fraudulent

these litigants into signing the subordination agreements.

But the trustee has no right to assert estoppel. Those dealing with the debtor relied primarily on the false financial statements, not the security provided by the net capital rule.

It seems to this court that reliance must be shown and that summary judgment is not appropriate.

"... summary judgment is a drastic device to be applied only when there are no material factual issues to be tried. In making that determination, the court 'must resolve all ambiguities and draw all reasonable inferences in favor of the party against whom summary judgment is sought' with the burden on the moving party to demonstrate the absence of any material factual issue genuinely in dispute." Heyman v. Commerce and Industry Insurance Co., 524 F.2d 1317, 1320 (2d Cir. 1975); Judge v. City of Buffalo, 524 F.2d 1321 (2d Cir. 1975). Gladstone v. Fireman's Fund Insurance Co., ___ F.2d ___ (2d Cir. 5/17/76; Docket #75-7435).

The issue of reliance is a material one essential to determining whether the court will impose promissory estoppel on the subordinated lenders. In light of the issue raised as to whether there was, in fact, reliance, summary judgment should not preclude a showing; resolution of this factual issue is necessary.

The trustee presses another ground to support summary judgment in his favor. He claims that the subordination agreement was made not only between his adversaries here and the debtor, but also between the former and the Exchange. Thus, the trustee goes on, the Exchange has separate contract rights in the subordination agreements independent of those possessed by the debtor's trustee. But any rights the Exchange might have are not affected by the debtor's alleged misrepresentations.

Insurance Co. of North America v. Brehm, 257 Ore. 385, 393-394, 479 P.2d 387, 391 (1971); Peoples Trust Co. v. O'Neil, 273 N.Y. 312, 316, 7 N.E.2d 244, 246 (1937). The debtor's creditors and customers are clearly the third party beneficiaries of the agreements with the Exchange and could themselves sue the subordinated lenders for specific performance of open promises. Pond v. New Rochelle Water Co., 183 N.Y. 330, 76 N.E. 211 (1906). Accordingly, the trustee could sue on the subordinated lenders' promises by his title to causes of action under Section 70a of the Act, 11 U.S.C. § 110a. The subordinated lenders vigorously and correctly disagree with the trustee's stand on this. There is no evidence of any contractual agreement between the subordinated lenders and the Exchange. The New York Stock Exchange was not a party to the Senior Subordinated Note Agreement which the lenders and the debtor executed on September 29; indeed, the Exchange was in no way involved in the dealings between the lenders and the debtor. Nor did the lenders enter into separate agreement with the Exchange to subordinate their rights. The fact that the transactions between the debtor and the lenders required Exchange approval does not make the Exchange a party to the transaction. Absent evidence of a subordination agreement with the Exchange, the trustee's theory falls.

The court therefore denies trustee's motion for summary judgment as an evidentiary hearing is needed in respect of the following material issues of fact: did the general creditors rely upon the subordination agreement or the net capital rule when they invested in or extended credit to the

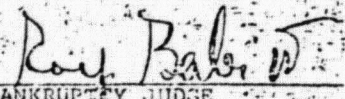
debtor: is there conclusive proof that the subordinated lenders entered into a separate subordination agreement with the New York Stock Exchange. If either of the above two questions results in an affirmative finding the trustee will be entitled to judgment. If reliance is proven, the subordinated lenders will be estopped from rescinding the agreement for fraud. In the Matter of Credit Industrial Corporation, supra, at 409. If an independent contract between claimant and the New York Stock Exchange is substantiated, that contract will remain in force regardless of any fraud perpetrated by Weis. Insurance Co. of North America v. Brehm, supra, at 392, 390.

If neither of the above questions is answered by an affirmative finding, it will become necessary to determine whether the debtor fraudulently misrepresented financial information of sufficient materiality to support rescission of the subordination agreement. In short, the court concludes that there is a two step inquiry which must be had and upon which findings must be made following trial. The second is reached only if the first is found in favor of the lenders.

Accordingly, summary judgment is refused by reason of the existence of material facts as to which the court is unable to make findings for want of probative evidence. Trial will be had on these issues following recourse to the discovery procedures carried in the Federal Rules of Civil Procedure and the Bankruptcy Rules incorporating the former. Upon

conclusion of all discovery, the court will fix a trial date after a pre-trial conference with counsel to be arranged on five days notice. Submit order.

DATED: New York, New York
July 15, 1976


BANKRUPTCY JUDGE

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

Received
Date 11/23/76

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In the Matter

: 73 Civ. 2332

of

: MOTION OF
WILLIAM J. SCOTT,
ATTORNEY GENERAL
OF THE STATE OF
ILLINOIS, EX REL
EVA GROSSMANN,
TO DISMISS THE
APPEAL OF THE
TRUSTEE.

WEIS SECURITIES, INC.,

:
Debtor.

----- x
Claims of George Aldrich, et al.,

:
Claimants.

----- x

NOW COMES WILLIAM J. SCOTT, The Attorney General

of the State of Illinois, ex rel EVA GROSSMANN, and respectfully
moves this Honorable Court to dismiss the appeal heretofore filed
by the Trustee in the above entitled cause for the reasons stated in
the Motions and Brief filed by the other subordinated lenders.

Respectfully submitted,

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State of Illinois

By

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STATE OF ILLINOIS)
) SS
COUNTY OF COOK)

PROOF OF SERVICE

CLAIRE CRBESEN, being first duly sworn upon oath, deposes and states that on the 18th day of November, 1976, she served copies of the foregoing Motion to Dismiss upon the following attorneys of record by first class mail, post paid, addressed to them as indicated:

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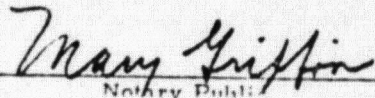
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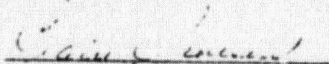
SUBSCRIBED AND SWORN TO
before me this 13th day of
November, 1976.


Notary Public

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----- x

In the Matter

of

WEIS SECURITIES, INC.,

73 Civ. 2332

Debtor.

----- x

Claims of George D. Aldrich,
et al.

----- x

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WYATT, District Judge,

These are two appeals from an order of Bankruptcy Judge Babitt filed August 26, 1976. Appellants are (a) the trustee for the liquidation of the business of Weis Securities, Inc. (Weis) under the Securities Investor Protection Act of 1970 (SIPA, 15 U.S.C. § 78aaa and following) and (b) the Securities Investor Protection Corporation (SIPC). The order appealed from denied a motion of the trustee for summary judgment sustaining his objection to the claims of 24 different claimants who were subordinated lenders to Weis (sometimes called "claimants" and sometimes "subordinated lenders"). A thoughtful opinion had been filed by the Bankruptcy Judge on July 16, 1976. I am persuaded, however, that the able Bankruptcy Judge was in error and that the order appealed from must be reversed.

1.

Weis had been a prominent registered broker-dealer and a member of the New York Stock Exchange.

The proceedings in which the trustee was appointed are described in Exchange National Bank v. Wyatt, 517 F.2d 453 (2d Cir. 1975). The trustee was appointed on May 30, 1973; the "filing date" (15 U.S.C. § 78eee(b)(4)(B)) was May 24, 1973. Weis is in liquidation under SIPA.

2.

The securities business is much regulated, necessarily so after the 1929 stock market crash and the conditions which preceded it.

The Securities Exchange Act of 1934 (15 U.S.C. § 78a and following; the 1934 Act) required brokers to have a certain amount of capital. Section 8(b) of the 1934 Act (15 U.S.C. § 78h(b)) required that the capital of a broker firm be at least 1/20 the amount of the total indebtedness of the broker firm. Expressed in another way, the 1934 Act was designed to protect the customers of a broker against his insolvency; this was to be done, among other ways, by preventing him from borrowing more than twenty times his net capital.

The New York Stock Exchange had its own rule as to net capital requirements. This was its Rule 325 which provided that the indebtedness of a member could not be more than 15 times the net capital of such member.

In 1938, the 1934 Act was amended to give the SEC authority to issue regulations with respect to the "financial responsibility" of brokers. 15 U.S.C. § 78o(c)(3) The SEC issued a regulation (17 CFR § 240.15c3-1) which provided that no broker could have indebtedness of more than 20 times his net capital. Because the New York Stock Exchange rule was more restrictive than this, the SEC regulation was not applicable to members of that Exchange. Weis was a member of the New York Stock Exchange.

3.

In meeting the net capital requirements of the SEC and of the Exchange, the practice developed of brokers borrowing money on a subordinated basis, that is, the lenders agreed

that their claims would be subordinated to general creditors. Where such agreements were approved by the Exchange, the indebtedness was excluded in calculating compliance with the net capital rule of the Exchange. This was an explicit provision of Rule 325(b) (2) (E) of the Exchange, which excluded from the aggregate indebtedness of a member "liabilities subordinated to general creditors pursuant to a separate agreement approved by the Exchange". In substance the subordinated loans, with the knowledge of the lenders, were used as capital for purposes of the net capital rules.

Weis, in attempting to comply with the net capital rules, borrowed from lenders who agreed that their claims would be subordinated to the general creditors of Weis. Also Weis had in 1969 bought certain assets from another broker-dealer, Winslow, Cohn & Stetson Incorporated ("Winslow"). Winslow was a member of the New York Stock Exchange and had borrowed from subordinated lenders.

It should be obvious, but may bear mentioning, that subordinated lenders are paid for the added risks which they knowingly assume. They receive all income from all securities loaned, in addition to interest at rates usually above normal. Here, for example, Weis undertook to pay 10% interest to most of the lenders and not less than 8%. We are told that in fact Weis paid \$750,000 to these lenders before the trustee was appointed.

After the trustee was appointed for Weis on May 30, 1973, claims were filed by some 50 subordinated lenders to Weis.

On April 24, 1974, the trustee filed an "application for an order confirming the trustee's position with respect to claims of subordinated lenders". This position was that the subordination agreements should be enforced in accordance with their terms, that claims of fraud by the subordinated lenders even if proved would not avoid the subordination agreements because every customer and creditor of Weis had relied on those agreements "either expressly or constructively", and that the claims of subordinated lenders to Weis should not be paid until the general unsecured creditors of Weis had been paid in full.

On April 24, 1974, Judge Babitt made and filed an order requiring the subordinated lenders and SEC and SIPC to show cause why the trustee's position should not be sustained.

This order to show cause was heard on July 16, 1974. Many of the subordinated lenders did not appear to oppose the position of the trustee. As to these, there was an "inquest" and the trustee's position as to them was sustained and this proceeding is no longer concerned with them.

As to 24 subordinated lenders who opposed the trustee's position, objections to their claims were then served by the trustee and filed on December 12, 1974.

Judge Babitt then made an order on December 13, 1974

requiring the 24 subordinated lenders to show cause why summary judgment should not be granted on the objections of the trustee to their claims and why the trustee's position should not be confirmed.

The hearing on the order to show cause was held on March 12, 1975.

On July 16, 1976, Judge Babitt filed his opinion and on August 26, 1976, the order here appealed from was filed. The order denied the trustee's motion.

5.

Each of the subordination agreements here in question was made with knowledge that the money (or property) loaned would be used as capital of Weis for satisfying the provisions of the net capital rules. Each provided that in any liquidation of Weis, the loan would not participate in any distribution of Weis assets until the claims of all general creditors of Weis were satisfied. Each of these lenders submitted an application to the Exchange for approval as a subordinated lender. Each of the agreements was filed with the Exchange. Each was approved by the Exchange for inclusion of the borrowed money or property in calculating the capital of Weis to determine compliance with the net capital rules. None of this was disputed before the Bankruptcy Judge. One of the subordinated lenders sought to avoid the substance of his agreements by a statement that he was "unfamiliar with such requirements" of the Exchange (Slater aff. ¶ 4). Another stated that while the papers were

signed and completed for the Exchange, the details were handled by Weis (Gardner aff. ¶4).

Now the subordinated lenders seek to avoid their subordination agreements by the claim that they were induced by the fraud of Weis to enter into those agreements. They thus ask in effect or expressly for rescission of their agreements and return of what they loaned to Weis.

The trustee contends that even if fraud on the subordinated lenders be assumed, these lenders are estopped as a matter of law to assert it because those of the public who dealt with Weis and who are now general creditors relied on compliance by Weis with the net capital rules and such compliance was made possible only by the agreements to subordinate. The trustee also contends that the subordination provisions were promises to the Exchange which relied on them in allowing Weis to continue as a member and to deal with those who thereby became general creditors in the present liquidation.

6.

In denying the trustee's motion, Judge Babitt ruled that actual reliance by the general creditors on the subordination agreements or net capital rule must be proved by the trustee in order to defeat the claims of fraud by the subordinated lenders. Judge Babitt also ruled that if the trustee can establish "an independent contract" between the subordinated lenders and the Exchange, "that contract will remain in force regardless of any fraud perpetrated by Weis".

It is far from clear how the ruling of the Bankruptcy Judge is intended to be applied. Must the trustee prove actual reliance by each customer creditor? Would failure to prove actual reliance by any one customer creditor mean that the subordination agreements could be rescinded as against all customer creditors or only as to that one customer creditor as to whom there was failure of proof? We are told by the trustee that there were 30,000 customers of Weis and by SIPC that there were 33,000 such customers. Would the trustee be required to prove actual reliance on each one of the subordination agreements of each subordinated lender? What would be the effect of a failure of proof as to one subordination agreement of one subordinated lender?

Normally these questions would be reached only after a trial of the fraud issue as to each subordinated lender and after at least one subordinated lender had established fraud by Weis. As to any subordinated lender who fails to prove fraud by Weis, the inquiry would normally be ended and the subordination agreement could be enforced according to its terms.

It seems, however, that the Bankruptcy Judge has in mind a reversal of this order of events. The trustee is first to prove reliance by the customer creditors. If he can do this, then proof of fraud will not be taken because irrelevant. If the trustee does not prove reliance, then the fraud issue is then to be tried as to each subordinated lender. If this be the contemplated procedure it seems illogical and unworkable.

It is not clear exactly what procedure is contemplated. However, the practical result of the ruling of the Bankruptcy Judge is clear. The burden of proof on the trustee could not be met as a practical matter and thus the subordination agreements on the strength of which Weis had been allowed to continue operating and to create claims of general creditors, could not be enforced.

7.

Judge Babitt concluded that "the controlling case" is In re Credit Industrial Corp., 366 F.2d 402 (2d Cir. 1966). It is believed that this conclusion is mistaken.

CIC, a commercial finance company, obtained its working capital by borrowing from (a) institutions and (b) individuals. The individual lenders were paid "a high rate (10%-12%) of interest" but their loans were agreed to be subordinated to institutional loans and not to be paid until CIC paid all its obligations to institutional lenders. CIC became a bankrupt. Its trustee sought to enforce the subordination agreement. The individual lenders asserted several separate defenses, two of which are significant here: (a) that the institutions did not lend to CIC in reliance on the subordination agreement and (b) that fraud was practiced on the individual lenders. The District Court had affirmed the denial of a motion to strike the defense described in (a) and the granting of a motion to strike the defense described in (b). The District Court believed that any subordination agreement,

however valid or lawful, could only be enforced in bankruptcy if actual reliance on the agreement by senior creditors could be shown. Under this belief, it was irrelevant whether fraud could be proved by the subordinated (individual) lenders because, whether there were fraud or not, reliance by the senior (institutional) lenders had to be shown.

The Court of Appeals reversed, holding that in bankruptcy the Court "must enforce lawful subordination agreements according to their terms" (366 F.2d at 410). Therefore, the separate defense described in (a) above should have been struck.

It was also held that the separate defense of fraud described in (b) above should not have been struck because the pleading stage was too early to decide whether proof of fraud would avail the subordinated (individual) lender. This "should await such disposition as the law and facts require after the relevant facts have been developed" (366 F.2d at 412).

The Court of Appeals did discuss but did not decide whether reliance must be shown to overcome a defense of fraud asserted by junior creditors. Such a defense was allowed to be asserted as a matter of pleading because it "may become important to the rights of junior creditors" (366 F.2d at 410-11; emphasis supplied); therefore "the noteholders here are entitled to assert" such a defense in their pleading (366 F.2d at 411). Elsewhere the Court of Appeals said: "Reliance

may become a relevant factor . . . where the subordination agreement itself is invalid" (366 F.2d at 409; emphasis supplied).

There was thus no decision by the Court of Appeals on the point here at issue; the discussion was dicta, and the decision is not controlling in the case at bar.

In any event, the situation in CIC was radically different from that at bar. In CIC, the subordination ran in favor of particular, described senior creditors and the motives for subordination were entirely private, having nothing to do with statutory requirements for a regulated business. In the case at bar, Weis and the subordinated lenders knew that the subordination was to meet the statutory requirements for a broker-dealer to continue in business and knew that it was for the protection of the general class of Weis customers who, as long as Weis continued to operate, were becoming general creditors of Weis.

8.

There is not only no controlling authority on the point here at issue; there are no decisions on the point.

We must consider, therefore, what equity and fairness would suggest. This seems clearly to be that, as between the customer and other general creditors of Weis on the one hand (for whom the trustee speaks) and the subordinated lenders on the other, the agreements of the latter should be enforced according to their terms in distributing the assets of Weis.

As between Weis and the subordinated lenders, the latter are entitled to rescind if fraud is proved; the trustee recognizes this. If the subordinated lenders prove fraud, their claims should be paid before anything is distributed to the stockholders of Weis. But the customer and other general creditors of Weis should be paid before anything is paid to the subordinated lenders. Every customer and general creditor of Weis knew, or is presumed to have known, that the broker-dealer business of Weis was regulated by federal law and that as part of such regulation the net capital rule was enforced. The subordinated lenders, by their agreements, enabled Weis to comply with the net capital rule and thus to continue in business. The customer and general creditors of Weis should therefore have priority. Under the circumstances, actual reliance is not required to be shown. If the reliance doctrine must be satisfied as a point of dogma, it should be presumed as a matter of law.

The bank assessment cases seem analogous. Before 1959 (for all practical purposes, before 1933), for many years shareholders of any national bank were by statute personally liable for "all contracts, debts, and engagements" of the bank, to the extent of the par value of their shares; this liability was enforced by assessment. 12 U.S.C. §§ 63, 64

Cases arose where shareholders defended against an assessment on the ground that their shares were sold by fraud of the bank to them and, since fraud gave them a right of

rescission, they were not really to be considered as shareholders. No such defense was allowed because the statutory liability was for the protection of depositors of the bank.

It was never suggested that actual reliance on the share ownership or the statutory liability had to be shown.

Such a case was Scott v. Deweese, 181 U.S. 202 (1901) where (at 213) it was said:

"The present suit is primarily in the interest of creditors of the bank. It is based upon a statute designed not only for their protection but to give confidence to all dealing with national banks in respect of their contracts, debts and engagements, as well as to stockholders generally. If the subscriber became a shareholder in consequence of frauds practised upon him by others, whether they be officers of the bank or officers of the Government, he must look to them for such redress as the law authorizes, and is estopped, as against creditors, to deny that he is a shareholder, within the meaning of section 5151, if at the time the rights of creditors accrued he occupied and was accorded the rights appertaining to that position."

A more recent and similar case is Oppenheimer v. Harriman Bank, 301 U.S. 206 (1937). Both sides appear to rely on this decision but in my view it supports the position of the trustee. Oppenheimer bought his stock in 1930. The bank closed in 1933 after which Oppenheimer sued for rescission for fraud and eventually secured a money judgment for the amount he had paid for the shares. The Court of Appeals, however, ordered that the judgment be paid only "after payment in full of all who were creditors when the bank became insolvent". This deferment of the judgment was reversed by the Supreme Court which ruled that the judgment was entitled to parity

with other unsecured creditors. This ruling was made, however, because Oppenheimer had already paid the statutory assessment against him. The significance for the case at bar is the repetition by the Supreme Court of the settled rule that fraud and the ability to rescind are of no avail to defeat protections by statute for a class of creditors. The Supreme Court, citing Scott v. Deweese, above, with approval, said (301 U.S. at 214):

"Plaintiff appeared by the bank's records to be a stockholder and, as against creditors for whose benefit the statutory liability was created, was estopped from denying that status. Recognizing that the bank's fraud and his rescission availed nothing against the comptroller's assessment, plaintiff paid the amount laid against him."

Nothing whatever was said about reliance by creditors on the share ownership or statutory liability.

An even closer analogy is found in an old New York case, Hurd v. Kelly, 78 N.Y. 588 (1879). A bank was in poor condition. To induce and enable the bank to continue in business Kelly gave the bank a bond, under circumstances strikingly similar to those here. As described in the opinion (at 595):

"It appears that when the bond was given the assets of the bank had become impaired to an amount as great or greater than the amount of the bond. The bond was executed for the purpose of being exhibited to the bank department as an asset so that the bank might pass the examination and inspection of the department and be enabled to continue its business."

Later the bank failed and a receiver was appointed who sued on the bond. Kelly defended by asserting that he was induced

by fraud to sign the bond. This was unanimously held to be no defense, the Court saying (at 596, 597):

"The intention of the parties was to provide a security in the nature of a guarantee fund of \$100,000, to enable the bank to continue its business. It is not claimed that the transaction was ultra vires, and if it was, that objection cannot prevail as against the claims of depositors who are represented by the receiver and who is seeking to collect the bond as an asset of the bank, for distribution among those for whose protection it was given.

"The defense that there was a fraudulent concealment by the persons who solicited the defendant to sign the bond, of the true condition of the bank, was, under the circumstances of this case, no answer to the action. It appears from the defendant's answer that he was informed, when he executed the bond, that it was to be used in reference to the relations of the bank to the banking department 'so that a better showing of the apparent assets of the bank would appear.' The defendant was thus apprised that this bond was to be used to give credit to the bank, with the bank department and with the public, so that it should be enabled to continue its business. The fact communicated to him was notice that the bank was in a precarious condition. He knew that if the bond was treated as an asset and the bank thereby allowed to continue its business, new obligations to depositors would be entered into on the faith of the solvency of the institution. Under such circumstances it would be gross injustice to permit the defendant, after having aided the bank to procure credit with the community to avoid, as against depositors and creditors, the payment of his bond on the allegation that the exact condition of the bank was not disclosed to him, or that it was much worse than was represented. The dealings between him and the officials of the bank, at whose request he signed the bond, ought not, in justice, to be allowed to affect the security given by him for the protection of those dealing with the bank and who must be presumed to have relied thereon in their dealings."

It may be noted that the receiver was not required to show that any depositor in fact knew of Kelly's bond or relied in any way on it. To the contrary, the depositors "must be presumed to have relied thereon in their dealings".

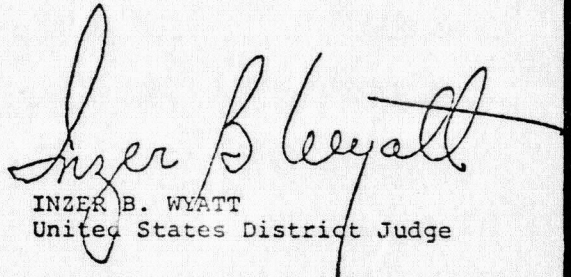
9.

Separate consideration should perhaps be given to an additional argument made by the Weis Employees' Profit-Sharing Plan and Trust ("Trust"), one of the subordinated lenders. The Trust argues that its claim should not be subordinated because it falls in, or close to, the category of "wages" given a priority status by Section 64(a)(2) of the Bankruptcy Act (11 U.S.C. § 104(a)(2)). The term "wages" in this section has not been liberally construed but has been limited to "money directly due [employees] in back wages." United States v. Embassy Restaurant, 359 U.S. 29, 32 (1959). Contracts in which an employees' trust loans money to the employer at higher than normal interest rates in return for its agreement to subordinate its claim to that of all other creditors scarcely falls within the classic pattern of "back wages".

The order appealed from is reversed and the matter is remanded to the Bankruptcy Judge for further proceedings consistent with this opinion.

SO ORDERED.

Dated: New York, New York
January 20, 1977


INZER B. WYATT
United States District Judge

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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In the Matter

of

73 Civ. 2332

WEIS SECURITIES, INC.,

NOTICE OF FILING
NOTICE OF APPEAL
and
PROOF OF SERVICE

Debtor.

----- x

Claims of George D. Aldrich, et al.

----- x

TO: All Parties on the Attached List:

PLEASE TAKE NOTICE that the undersigned has this 10th day of February, 1977, mailed for filing to the Clerk of the United States District Court, Southern District of New York, a Notice of Appeal, a copy of which is attached hereto and herewith served upon you.

WILLIAM J. SCOTT
Attorney General of the State of Illinois
Attorney for Eva Grossmann

By Fred F. Herzog
FRED F. HERZOG
Special Assistant Attorney General
160 North LaSalle Street - Suite 800
Chicago, Illinois 60601 (312) 793-5635

PROOF OF SERVICE

STATE OF ILLINOIS)
) SS
COUNTY OF COOK)

CLAIRE ORBESEN, being first duly sworn upon oath,

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----- x
In the Matter

of

73 Civ. 2332

WEIS SECURITIES, INC.,

NOTICE OF
APPEAL

Debtor.
----- x

Claims of George D. Aldrich, et al.
----- x

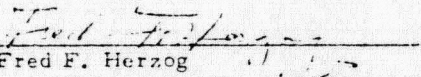
NOTICE IS HEREBY GIVEN that Eva Grossmann, one of the claimant-subordinated lenders in this matter, hereby appeals to the United States Court of Appeals for the Second Circuit from the Order of the United States District Court for the Southern District of New York reversing the Order of the Bankruptcy Court and granting a summary judgment to the Trustee for the liquidation of the business of Weis Securities, Inc., entered in this action on the 21st day of January, 1977.

WILLIAM J. SCOTT

Attorney General of the State of Illinois
Attorney for Eva Grossmann

Dated: February 9, 1977

By


Fred F. Herzog

Special Assistant Attorney General

160 North LaSalle Street - Suite 800

Chicago, Illinois 60601 (312) 793-5635

deposes and states that she has served copies of the above and attached Notice of Filing and Notice of Appeal upon each of the parties named on the attached list, at the addresses given, first class mail, postpaid, this 10th day of February, 1977.

Carrie Howell

SUBSCRIBED AND SWORN to
before me this 10th day of
February, 1977.

Maria Griffin
Notary Public

Milbank, Tweed, Hadley & McCloy
1 Chase Manhattan Plaza
New York, NY 10005
Att'ys. for N.Y. Stock Exch., Inc.

Baer & Marks
70 Pine Street
New York, NY 10005
Att'ys. for Fidelity Corp.

Hahn, Hessen, Margolis & Ryan
350 5th Avenue
New York, NY 10001
Att'ys. for Exchange Nat'l. Bank
of Chicago

Miller, Singer, Michaelson,
Brickfield & Raives
555 Madison Avenue
New York, NY 10022
Att'ys. for Eva Grossmann

Patterson, Belknap & Webb
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New York, NY 10020
Att'ys. for Milton S. Gould

Stroock, Stroock & Lavan
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Michael E. Don, Esq.
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Att'ys. for Securities Investor
Protection Corporation

Stackpole & Amidon
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Stowe, VT 05672
Att'ys. for Arthur J. Kreizel

Dickstein, Shapiro & Morin
1735 New York Avenue, NW
Washington, D.C. 20006
Att'ys. for Claimants
Aldrich et al.

Hughes Hubbard & Reed
One Wall Street
New York, NY 10005
Att'ys. for the Trustee

Rogers & Wells
200 Park Avenue
New York, NY 10003
Att'ys. for Security Nat'l. Bank

Trachtenberg & Winick
500 5th Avenue
New York, NY 10036
Att'ys. for Gen. United Life
Ins. Co., All American
Life & Casualty Co. and
Robert Slater

Lipkowitz, Plaut, Salberg &
Harris
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Att'ys. for Arthur J. Kreizel
and Ester Levick

Shea, Gould, Climenko & Kramer
330 Madison Avenue
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Att'ys. for Sol Kittay

Williamson & Schoeman
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60 East 42nd Street
New York, NY 10017
Att'ys. for Jesse Reid Deitz

Dunning, Bartholow & Miller
161 East 42nd Street
New York, NY 10017

Robert J. Millstone, Esq.
Special Counsel
Securities and Exchange
Commission
500 North Capitol Street
Washington, D.C. 20549

NEW YORK STOCK EXCHANGE RULE 405

Rule 405. Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) [§ 2342] to

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

Supervision of Accounts

(2) Supervise diligently all accounts handled by registered representatives of the organization.

Approval of Accounts

(3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) [§ 2342]. The member, general partner, officer or designated person approving the opening of the account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization.

Common Sales Accounts

(4) To facilitate the isolated liquidation of securities valued at \$1,000 or less registered in the name of an individual who does not have an account, and which are not part of any distribution, a member organization may sell the securities through a common sales account set up for the specific purpose of handling such sales without sending a periodic statement to the customer as required by Rule 409, provided:

a) The customer is identified as the individual in whose name the securities are registered.

b) The securities are received by the member, at or prior to the time of the entry of the order, in the exact amount to be sold in good delivery form.

c) A confirmation is sent to each customer.

d) All proceeds of such sales are paid out on or immediately following settlement date, and

e) The record made in the common sales account includes as to each transaction: customer's name and address, name and amount of securities to be sold, date received, date sold, amount per share, total amount credited to the account, total amount of check issued to the customer and the date of disbursement.

PROOF OF SERVICE

In the

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

In the Matter of
WEIS SECURITIES, INC.,
Debtor.

GEORGE ALDRICH, et al.,

vs
EDWARD S. REDINGTON, Trustee under
SECURITIES INVESTOR PROTECTION
CORPORATION,

Appellants,

Appellees.

No. 77-6034

The undersigned being first duly sworn, deposes and says that he served 2 copies of the BRIEF FOR APPELLANT, EVA GROSSMANN in the above entitled cause by depositing the same in the United States Mail at Chicago, on the 7th day of May, 1977 properly stamped and addressed to

Mr. Sidney Dickstein
Dickstein, Shapiro & Morin
2101 L. Street, N.W.
Washington, D.C. 20037

Miller, Singer, Michaelson,
Brickfield & Raives
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New York, New York 10017

Zalkin, Rodin & Goodman
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Mr. Yale D. Tauber
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Mr. Thomas P. Luning
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Messrs. James W. Giddens
and James B. Kobak, Jr.
Hughes, Hubbard & Reed
One Wall Street
New York, New York 10005

Messrs. Theodore H. Focht,
Wilfred R. Caron and
Michael E. Don
Securities Investor Protection Corporation
900 17th Street, N.W., Suite 800
Washington, D. C. 20006

Subscribed and sworn to before me
this 7th day of May, 1977
My Commission expires 11-27-77.

Patrick A. Kessler
Notary Public

William Henderson

